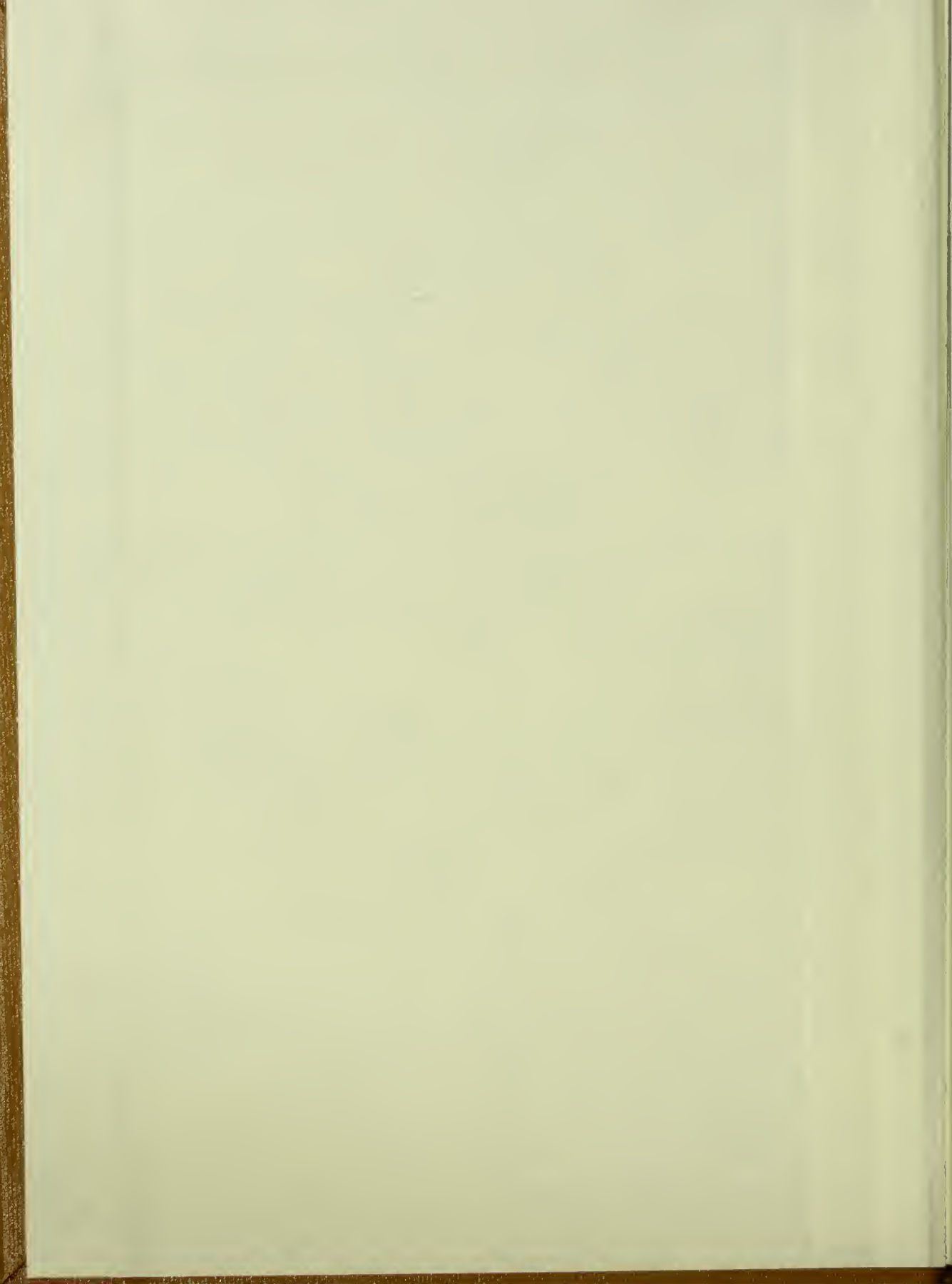


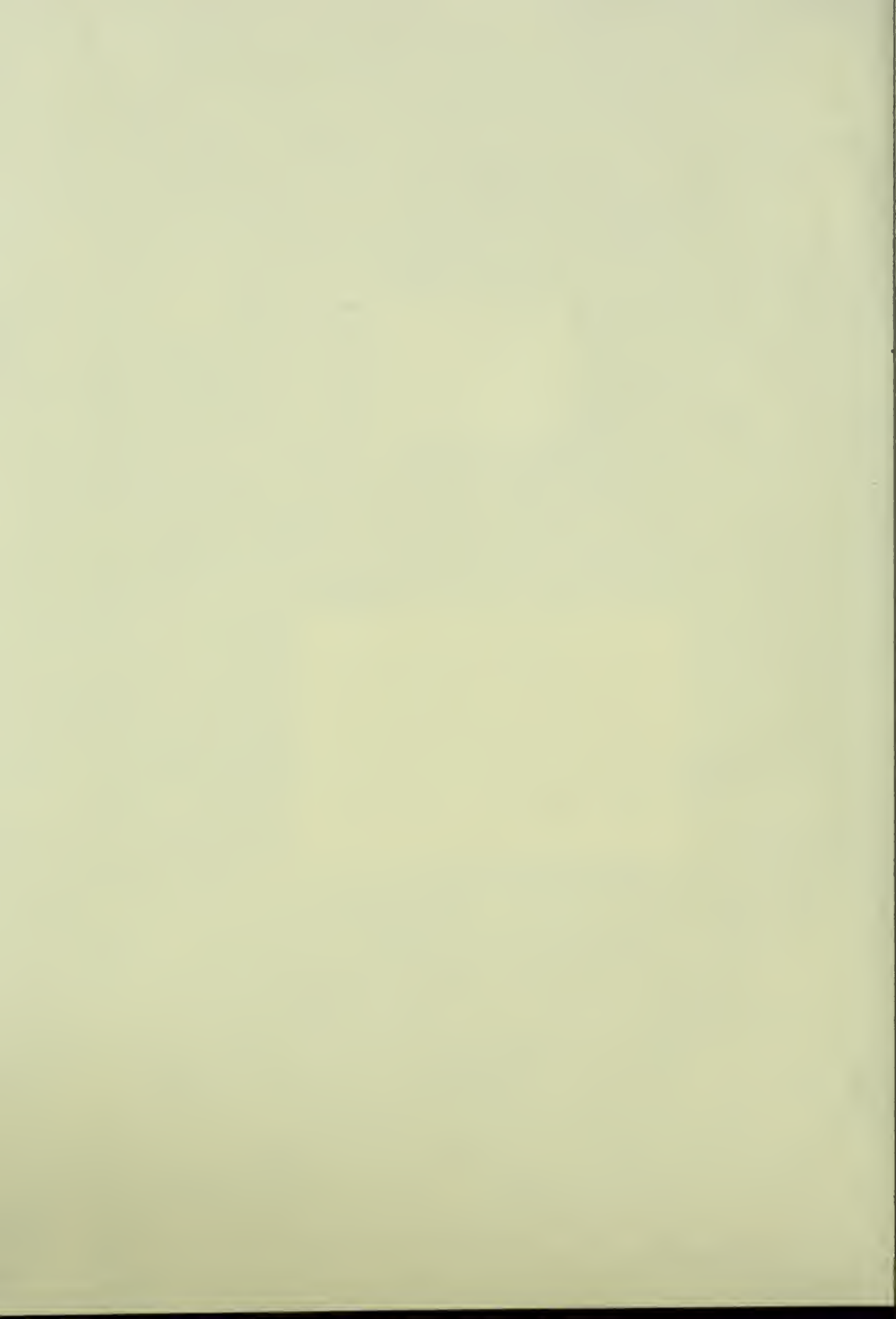




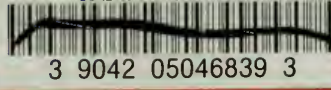
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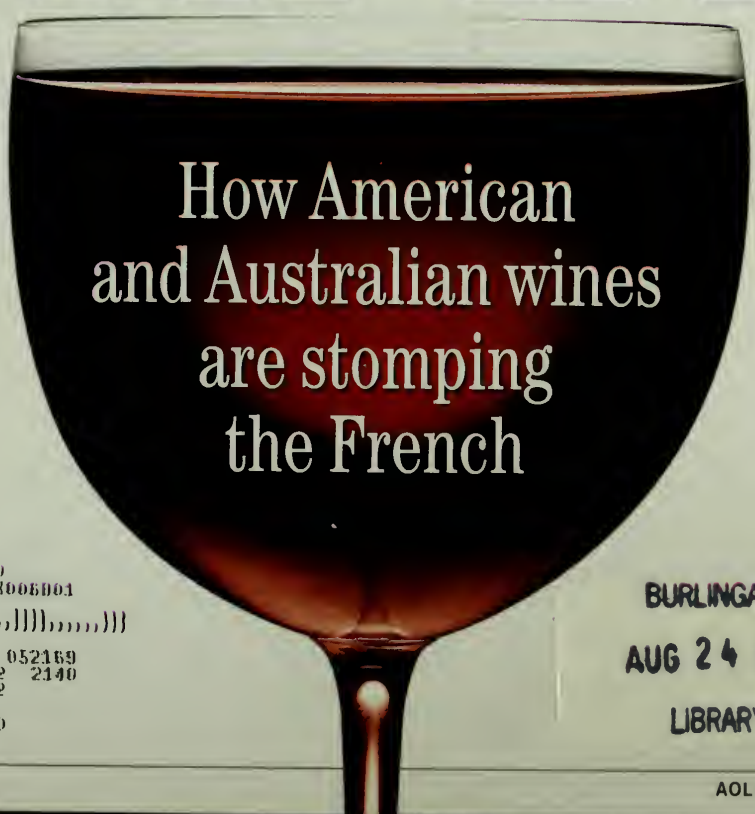
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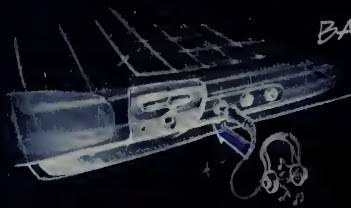
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COVER STORY

FADING BOUQUET

The artisan traditions of the great French wineries are running head-on into the unyielding demands of the global market

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S&P's Robert Gold explains why he's positive on health-care services and devices stocks



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Finding one with an astute manager is key in this complex field, says BW's Carol Cropper



TOOLS

YOUR PORTFOLIO:

Check in on the health of your investments



STOCK SCREENER:

Use more than 70 criteria to pan for gold among the equities



MBA SEARCH: Which is the right business school for you and your needs?



SALARY SURVEYS: How much money should you be paying your staff?



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Do Your Duty!

Regret having but one refund check to spend? Then make it count. Here are some tips on helping to revive the economy



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COMMENTARY: It's easy to dismiss the parallels between 1929 and now as superficial, but the similarities ring with unsettling echoes



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Up Front

EDITED BY SHERIDAN PRASSO

THE ECONOMY

BUFFETT FORECASTS EIGHT BAD YEARS

IF YOU'RE LOOKING FOR A rosy economic forecast, don't knock on Warren Buffett's door. Seems the Berkshire Hathaway chairman and King of All Value Investors has been telling the executives he meets with to brace themselves for a long slowdown. Not only is there no turnaround in sight this quarter or even this year, according to Buffett, but those who've met with him say that he is predicting



C'MON say it ain't so

eight years of economic stagnation. Buffett attributes the standstill to a "hangover effect" from the excesses of the late 1990s, says one private equity investor who has heard the Sage of Omaha's reasoning.

Buffett generally doesn't speak to the press, and questioning his headquarters about his economic forecast proved to be no exception. But if the 70-year-old business guru is right—as he so often has been in the past—his strategy of rational investing for the long term is going to look even smarter down the road. *Heather Timmons*

PAC MENTALITY

GANGSTA POSSE ON CAPITOL HILL

WASHINGTON, D.C., IS A center of hip-hop culture, but that usually doesn't extend to Capitol Hill. Soon it will. Get ready for Snoop Dogg and Dr. Dre chomping on chilled shrimp at Hill fund-raisers:



RAPPERS will fight pending legislation

The music genre with the outlaw image is forming a political action committee. Nu America is the creation of rappers and music moguls trying to improve hip-hop's reputation while heading off labeling requirements and restrictions, such as pending legislation that would prohibit marketing adult-rated

entertainment to children.

The PAC has a platinum lineup: Def Jam Records founder Russell Simmons and former NAACP President Benjamin (Chavis) Muhammad, who is no stranger to controversy since his 1994 ouster from the civil-rights group. He talks of flexing "some political muscle" on issues including censorship, racial profiling, voter registration, and funding for inner-city schools. The Reverend Al Sharpton, Louis Farrakhan, MTV, the NAACP, and a host of record labels pledge to help.

While the music industry has long been a potent lobby, never before has a specific genre formed its own PAC. Backers note that hip-hop is a \$2 billion-a-year industry. Says DePaul University professor Michael Eric Dyson, who studies hip-hop culture, if fans flock to the polls at the urging of music idols, they'll be "one of the most powerful" untapped constituencies yet. Word. *Rod Kurtz*

NEWS FLASH Vacancy rates on Sand Hill Road, headquarters of Silicon Valley's venture-capital community, have gone from absolutely zero last year to 7.5%. Next month, they expected to hit 11%—a number not seen since the early '90s

—San Jose Mercury News

BACK TO SCHOOL



NO. 2 PENCILS, NOTEBOOK... AND A PALM II

ADD "THE DOG ATE MY PALM PILOT" TO THE LIST OF HOMEWORK excuses this fall—that is, if you're a student at Forsyth Country Day School. The posh private high school in Winston-Salem, N.C., will be the first in the nation to require all students to purchase a Palm IIIC this fall. Not even such r Eastern prep schools as Andover and Phillips Exeter. But Forsyth has embraced the devices as versatile alternatives to the laptop.

At \$200, a Palm costs one-fifth the price of a laptop. It can download assignments and beam finished work to a printer. With special software and keyboard attachments, students can use Palms as word processors for English class and pH detectors for science class. "It's a lot simpler than the laptop solution," says Assistant Headmaster Eric Peterson.

Public and private schools around the country are increasingly experimenting with personal digital assistants. The Orland Park school district near Chicago bought 3,000 Palms last year for its 7,580 students, becoming the largest school system in the country to integrate them into its curriculum. This year, Palm has provided discount handhelds to 175 classrooms from Pennsylvania to Wisconsin and offers teacher training on how to use them. Martha Rolley, director of marketing for Palm's K-12 Div., says she's "mobbed" by school administrators at trade shows.

But what about Johnny beaming final exam answers to his friends? Teachers will just have to be more vigilant than ever. *Brian Grow*

THE LIST LABELS

WHAT TEENS WANT

Teenagers are notoriously fickle consumers, but the list the same few clothing brands as their top back-to-school preferences:



TEEN GIRLS 2001

1. OLD NAVY
2. GAP
3. TOMMY HILFINGER

TEEN GIRLS 2000

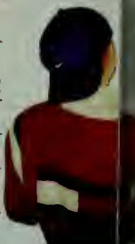
1. GAP
2. OLD NAVY
3. TOMMY HILFINGER

TEEN BOYS 2001

1. TOMMY HILFINGER
2. NIKE
3. ADIDAS

TEEN BOYS 2000

1. NIKE
2. TOMMY HILFINGER
3. OLD NAVY



Survey of 495 teens, July, 2001
Data: American Express Co.



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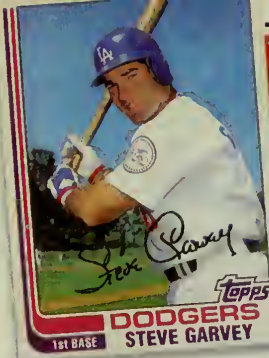


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BALLPARK FIGURES

DIAL 'L' FOR LEGEND

BASEBALL FANS HAVE BEEN known to pay \$100 for an autographed ball and \$500 for a bobblehead doll of their favorite players. So what would they be willing to shell out for a private chat?

Call of Fame is betting on \$4.95 a minute. That's for up to 10 minutes talking with about 200 old-timers enlisted to sit by their telephones from 6 p.m. to 9 p.m. (in their respective time zones) a couple nights a week and schmooze with fans. Former players for the Cubs, Dodgers, Mets, Red Sox, and Yankees are already taking calls or will be by summer's end. Dodgers ex-pitcher Don Newcombe is one, as are All-Star first baseman Steve Garvey and 1960s outfielder Andy Kosco, whose claim to fame was his oversized eyeglasses. Cubs fans get ex-pitcher and Hall of Famer Ferguson Jenkins, among others. Callers can request a team, but not a player.

The old-timers get a cut from each call they take and additional cash if they sell an autographed photo for \$11 to \$35. Call of Fame, based in Beverly Hills, gives them a manual with tips on what to say when the conversation drags. Calls have been slow so far. But, says former Dodger star Ron Cey, who works for Call of Fame: "The potential for this is enormous. These guys have so many stories to tell, it's unbelievable." The number: 800 352-3959. *Mark Hyman*

Up Front

FOREIGN EXCHANGE

WHY THE GREENBACK LOOKS EVERGREEN

AFTER YEARS OF KRYPTONITE strength, the dollar has fallen 9% vs. the euro since July.

But the plunge may not continue. The U.S. lured a huge surplus of money last year, while capital fled from Japan and Europe. Dollar-doom scenarios miss why money keeps pouring into the U.S., says Paul Podolsky, chief foreign exchange strategist at FleetBoston Financial, whose Creative Destruction Index ranks 25 countries annually. (The term refers to new technologies replacing old ones.) Reasons include a growing U.S. population and embrace of the Net, says Podolsky. Higher birth



THE BIG PICTURE

THE BITE FROM BENEFITS

For companies, benefits eat up a greater share of employee compensation costs for blue-collar workers than white collars. Higher insurance and workers' compensation are mostly to blame.

Percentage of total employee compensation that goes to:	White-Collar Workers	Blue-Collar Workers
All benefits	26.4%	30.6%
Life, health, and disability insurance	6.2%	7.7%
Paid leave	7.4%	5.8%
Workers' compensation	0.8%	3.0%
Sick time	1.2%	1.6%

BASED ON DATA FROM 3,800 BUSINESS AND GOVERNMENT OFFICES, MARCH 2001
Data: Bureau of Labor Statistics

and immigration rates vs. Europe and Japan also contribute to growing U.S. demand.

The index ranked the U.S. No.1 overall and in Internet use and percentage of college-educated people. Even Mexico (No.10) beat out the euro zone (No.14)

because of its more flexible economy, growing population and strengthening peso. did South Korea (No.12) because of its high Internet penetration rate, among other factors. "Whenever you mention things like demographics and changing technology affecting currency, people think you're nuts," says Podolsky. "But actually I think it makes a huge difference." *Julia Lichtblau*

WORDS, WORDS, WORDS

WHAT WE HAVE HERE IS...

YOUR BOSS PULLS YOU ASIDE in a meeting to "talk offline" about your "action items." Translation? She wants to chat later about your to-do list. Why can't she just use plain English?

Because corporate gobbledegook is still on the rise, communications experts say—Dilbert cartoon parodies notwithstanding. A study from British employ-

ment agency Office Angels finds 20% of workers believe it necessary to use jargon to keep up, even if they don't know the words' meanings. In the U.S., it's more like 60%, says Steve Crescenzo, whose Chicago-based consultancy helps corporate clients improve internal communication. "Nobody wants to say these words are empty and mean-

ingless and vague and vacuous," says Crescenzo. "So they all pretend they know. And they all continue to use them." Plus, people often use jargon to try to signal superiority, says New York University professor Irv Schenkler: "You have people in finance who can't talk to people in operations who can't talk to people in IT."

But even if companies do eliminate "synergy" from their lexicons, count on more words springing up to take its place. *Eric Wahlgrun*



I love dissecting humans.

Eileen Cuesta

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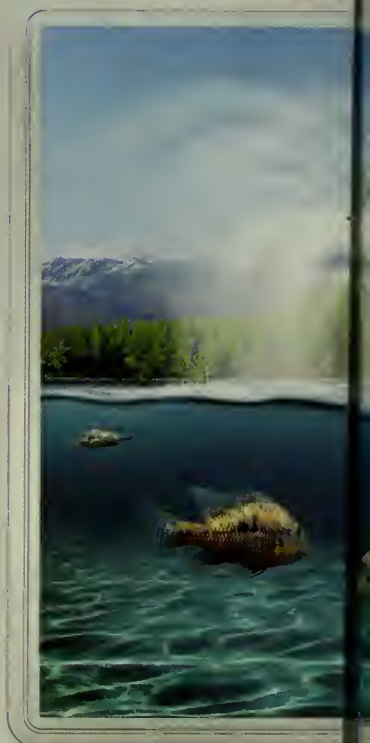


INSURANCE IN ACTION Consider forming an in-house safety team in order to evaluate and record accidents as they happen. Also, report accidents immediately to insure accuracy.



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BRANDING: IT'S ALL IN THE EYE OF THE BEHOLDER

One of the few hard facts about brands is their intangibility ("The best global brands," Cover Story, Aug. 6). They cannot exist anywhere but in the minds of customers, employees, suppliers, retailers, or even competitors. In "avoiding the vagaries of consumer perception surveys," you omit the single most important factor in creating and building brand equity: human perception.

Stephen Walker
New York

Quality guru W. Edwards Deming would be turning over in his grave if he knew of the efforts being made to quantify something that cannot honestly be quantified. Attempting to put a value on brands is time-consuming and, ultimately, meaningless—except for the consultants who will profit from this fad.

Steven G. Brant
Brooklyn, N.Y.

I would not go so far as to state that Gerry Khermouch's commentary, "Why advertising matters more than ever," is totally self-serving, but it would fit better in your ad sales presentations.

Harley Schnall
New York

In a turbulent economic environment, advertising may be the Dramamine (there's a great brand) for an advertiser's brand communications efforts. Advertising provides consistency and stability during a bumpy ride. Give in to the temptation to cut back, and you may find your brand a little green

around the gills for the duration of the rough ride and after the seas calm.

David A. Pa
Chairm

American Advertising Federat
Washing

Editor's note: The writer is also CEO DDB Group/Los Angeles.

Your otherwise excellent article ignored privately owned brands such as Mars and LEGO. LEGO appears in Concise Oxford English Dictionary—a recognition achieved by only one brand on your list, Xerox.

Peter
Retired Presid
LEGO Systems
East Granby, Co

I shed a tear that we reigned for a half-century as the world's most widely recognized trademark not among your top

The dog, Nipper, listening to "His Master's Voice" on a gramophone. The sign was introduced by my grandfather microphone and gramophone inventor Emile Berliner, in 1900.

Oliver Berl
Beverly H

THERE'S MORE THAN ONE KIND OF RACISM

"Racism in the workplace" (Social issues, July 30) is nothing more than superficial sensationalism. The article fails to cover the more subtle, yet equally damaging, forms of racism: glacially slow advancement of qualified minorities, highly selective hiring criteria favoring minority candidates, and blatant job mismatches—which often lead to the failure of the employee, only to be counted

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Readers Report

CORRECTIONS & CLARIFICATIONS

What doesn't belong in your 401(k)" BusinessWeek Investor, July 30) inaccurately quoted Joel Dickson, a tax-efficiency expert at Vanguard Group, as saying that you would do better to hold an S&P 500 fund for 20 years in a regular, taxable account—rather than in a 401(k). The article should have stated that this assumes a person invested \$10,500 in pretax dollars in the 401(k), vs. \$10,500 in aftertax dollars in the taxable account.

"The spoils of success" (Corporations, Aug. 6) erred in saying that Immunex' drug Envel was pulled from the market.

"In the market for a golf course?" (Up Front, Aug. 20-27) said that the purchase of Pebble Beach Golf Links by a group of American investors had fallen through. In fact, the deal closed in July, 1999.

In the response: "We hired one, and he didn't work out." Some liberal whites may be horrified, but most black readers probably skim the article and say, "Yeah, what else is new?"

Dwight J. Browne
Brooklyn, N.Y.

I read your article on racism with sadness that this is still going on, especially among professionals. But I like to turn the tables on these stories. In my country, a white man cannot make derogatory remarks about women or other races without serious repercussions. But what happens when a woman says she cannot get ahead because of a good-ol'-boys network, or when a black person says the white man is keeping him down? Nothing.

I tell the minority teens I work with that there is a certain amount of prejudice in any group, whether it's blacks, whites, Latinos, Asians, men, or women. Only white men are expected to change, and this makes me, as a white man, a better person. Then I ask them to look aside to see where they are prejudiced and how they can improve.

Ray J. Wallin
Minneapolis

TY SLICKERS CAN BE NO SLICK WITH STEREOTYPES

In the same issue with an article about racial discrimination, an illustration in "Craig McCaw's space shot" (Information Technology, July 30) perpetuates a stereotype of rural people as intelligent: The city user is smartly

dressed, while the rural user appears to be several bales short of a load.

Edward E. Rigdon
Conley, Ga.

COMMON GROUND IN THE GLOBALIZATION DEBATE

Protests won't stop globalization ("Time to regroup," News: Analysis & Commentary, Aug. 6). But they may influence political leaders to include other voices in the decision-making process.

There is one model where companies, social and environmental advocates, governments, and labor have come together to achieve progress on a key issue of globalization—accountability. This unlikely partnership, known as the Global Reporting Initiative, has designed a common framework for public disclosure of corporate environmental and social performance. More than 100 companies are already using the guidelines.

Robert Kinloch Massie
Global Reporting Initiative
Boston

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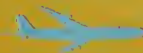
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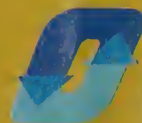
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THE MAP THAT CHANGED THE WORLD
 William Smith and the Birth of Modern Geology
 By Simon Winchester
 HarperCollins • 329pp • \$26

THE SCIENTIST TIME FORGOT

To the pantheon of 19th-century scientists that includes Charles Darwin, Louis Pasteur, Michael Faraday, and Gregor Mendel, author Simon Winchester would like to add the name William Smith. A self-educated surveyor and consultant on coal mining projects, Smith was one of the first to suggest that rock strata beneath the earth's surface could be identified by the characteristic fossils found in each layer. He used his understanding to create the first map of England depicting the geological strata. This achievement, according to Winchester, paved the way for Darwin's world-altering insights into evolution, and it is the focus of Winchester's new book, *The Map that Changed the World: William Smith and the Birth of Modern Geology*.

In this well-researched narrative, the author follows the same formula he used so effectively in his 1998 best-seller, *The Professor and the Madman*, which described the genesis of the *Oxford English Dictionary*. Both books highlight the often unlikely sources of great intellectual achievements, but the formula doesn't work quite so well in the latest book. For one thing, there are jarring gaps in the narrative. Moreover, while the eponymous map is Smith's achievement alone, he had no monopoly on early geological theory. Winchester damages his case by straining to hoist Smith's contribution high above those of other pioneers in the field.

The idea of a stratigraphic map may not grab many readers, but the contours of Smith's life, laid out in the prologue, probably will. Born in 1769, he spent two decades at the turn of the century crisscrossing thousands of miles of the English countryside, scrutinizing stones and fossils, exploring the deepest reaches of coal mines, and piecing together a three-dimensional picture of the earth's surface layers. His vast

knowledge earned him the nickname Strata Smith—along with modest wages from the aristocrats whose country estates he helped dredge.

Smith completed his magnificent 8½-foot-by-6-foot color drawing in 1815, only to have it plagiarized by a patrician clique of armchair geologists. The revenues Smith counted on from the map never materialized; he sank into poverty, and his wife went mad. Only after Smith was forced to spend months in a debtors' prison and several years in exile from London did his supporters manage to restore his reputation, giving him at least a taste of financial security and academic respect before he died in 1839.

The gritty practice of geology comes to life in the capable hands of Winchester, who holds a degree in the field from Oxford University and worked as a geologist in Africa. He opens a window onto England's coal-fueled economy at the turn of the century, with vivid descriptions of the mines and the canals that were constructed to barge the coal. Smith consulted on these engineering projects, which earned him money, the chance to travel, and a close-up view of the rock faces.

Not surprisingly, all that digging unearthed an extraordinary wealth of petrified plants, sea animals, dinosaur bones, and other fossils, which became drawing-room trophies in wealthy estates across the land. Their true age wasn't determined until the invention of radiometric dating, early in the 20th century. But even in Smith's time, people surmised that the fossils were thousands—if not millions—of years old and that most of the species were extinct. The presumed spans of time and the very idea of extinction undercut contemporary creationist views of the

world—views to which Smith himself subscribed. All of that is good grist for Winchester, who summarizes the great debates on evolution and even pauses one point to provide a refresher course in geology in the form of a walk through rockscapes of his childhood.

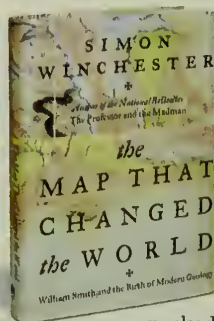
The dramatic climax comes in the last 50 pages of the book. The costs of Smith's incessant field trips, plus his bad investments in real estate and mining projects, mired him in debt, forcing him to sell off his treasured fossil collection. Smith ultimately lands in King's Bench Prison—at which point Winchester hits a serious roadblock. "The horrors of [Smith's] imprisonment and miseries of his marriage remain two great nonsubjects in William Smith's recorded life," the author abruptly informs us. "All reference to the has been expurgated from his works...and from all other contemporary accounts." That's disturbing, since Winchester has foreshadowed the events with gusto earlier in the book.

What's more, Winchester never names the precise nature of Smith's scientific contribution. We are told repeatedly that he paved the way for Darwin, but the connection isn't explicit. Certainly, other geologists of the period, such as Charles Lyell, played a far greater role on the intellectual stage. When Darwin prepared for his journey on the Beagle, in 1831,

he packed the first volume of Lyell's *Principles of Geology*. Did he ever peruse a similar tribute to Smith's scratch writings, or study his famous map? Winchester doesn't say.

All of which left me puzzled, at times, with the author's choice of Smith as the subject of a biography. Wedged among such giants as Darwin and Mendel, Smith seems uncomfortably out of place. Still, this book offers many attractions, not least the beautiful images of the map. Winchester makes the science accessible and captures some of the intellectual crosscurrents at the dawn of geological science. In both regards, it does readers a service.

BY NEIL GROSS
 Gross is senior editor for science and technology.



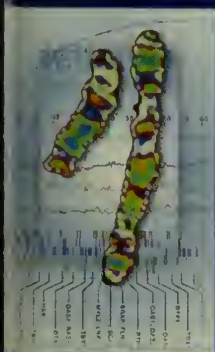
SMITH'S MAP OF FOSSIL-LADEN ROCK STRATA HELPED UNDERCUT CREATIONIST WORLDVIEWS

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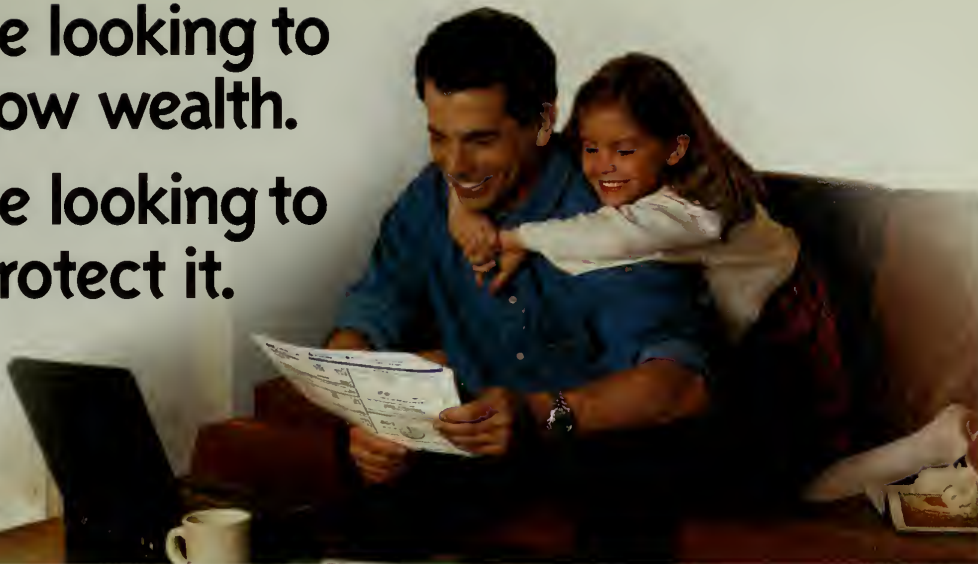
SUZE ORMAN IS THE OPRAH OF PERSONAL FINANCE, sometimes mawkish but often insightful. In *The Road to Wealth*, this month's No. 6 hardcover, Orman forgoes her usual psychological counseling for a deft nuts-and-bolts discussion of 11 personal-finance topics, from debt management to annuities. The entire volume is structured as a long Q&A—"Is taking out a 401(k) loan easy?" and "What is an open-end fund?" to select two queries at random. This makes the 561-page book more of a reference manual

than something you would want to read straight through.

This reviewer found the book's "Home Ownership" chapter particularly useful. Ever been baffled by references to 5/28/7/23 mortgages? Orman describes these two-step home loans which usually blend aspects of fixed- and adjustable-mortgages. Other worthwhile chapters tackle stocks, retirement planning, and bonds. All in all, it's a handbook that can benefit a wide range of readers.

BY KARIN PEKARC

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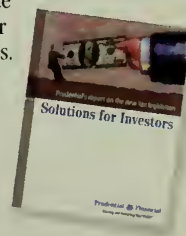
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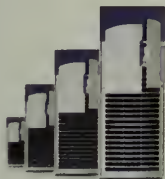
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BY STEPHEN H. WILDSTROM

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IMPERFECT-AND INDISPENSABLE



PCs have flaws. But the machines work well enough for most—and they're cheap

Twenty years ago, a rather reluctant IBM unleashed the homely Personal Computer 5150 and created the business PC. Since then, speed has increased by many orders of magnitude, the basic unit of storage has gone from the 160-kilobyte floppy disk to hard drives that hold tens of billions of bytes, and the price per unit of processing power has fallen perhaps a millionfold. Yet the fundamental architecture of the PC has changed amazingly little. In fact, most programs and hardware accessories that worked on the original IBM PC still work today. Plug an early 1980s Epson MX-80 dot-matrix printer into a Pentium 4, and it will be ready to chug away. What accounts for this longevity? And what does it portend for the future of personal technology?

Probably the most important lesson is that technological elegance isn't terribly important in the marketplace; being good enough will do. IBM's requirement that the PC be built from cheap, off-the-shelf parts forced engineering compromises that persist today. Over the years, techno-snobs have derided PC hardware and the software that runs on it, with Sun Microsystems CEO Scott McNeely famously dismissing Microsoft Office as "a hairball." None of this has mattered. "It wasn't rocket science, and it wasn't extraordinarily inventive," says IBM Fellow Mark Dean, who designed the color-graphics adapter for the original PC. "Most of the time it's not the level of technology that makes a difference. The important thing is that you are solving a problem at the right time and at the right price."

FIERCE RIVALRY. The PC became a vital business tool after Lotus Research introduced the 1-2-3 spreadsheet in 1983. At about the same time, IBM, which never tried very hard to retain exclusive control of the basic design, lost control of the tech-

nology to Microsoft and Intel. The consequence has been fierce competition among PC makers and a steady slide in prices.

The first real challenge to the PC's dominance was the introduction of the Apple Macintosh in 1984. The Mac was and is technically more elegant than its Intel-Microsoft rivals. But it was a closed system, compared to the PC's competition-inspiring open architecture, and Apple claimed a price premium. By the time Microsoft narrowed the usability gap with the introduction of Windows 3.1 in 1991, Apple Computer's chances of making significant inroads were slim. The PC wasn't the best, but it was good enough.

In the early 1990s, the PC reigned unchallenged. But by the second half of the decade, the growth of the Internet created new competition in the form of "network computers" and, more recently, "Web appliances." These were simpler terminals that depended on the processing power and intelligence of network servers. Despite the backing of such heavyweights as Sun, Oracle, and IBM, network appliances failed miserably. The reason is no mystery: They delivered a small fraction of the performance and flexibility of even a low-end PC at a large fraction of the cost. Another challenge to the PC has come from handheld devices. But too many tasks depend on a good keyboard and a big display for the pocketable tools to be more than adjuncts.

I have been as vocal as anyone in criticizing the PC's many flaws. The computers are still hard to use. Software quality leaves much to be desired, and consumers are expected to put up with a lot of failure and frustration that they would not accept from any other product. Yet I have to admit that the reliability of the hardware and the usability of the software have improved dramatically over the two decades.

In one sense the PC's glory days are over. Many markets are largely saturated, and even a return to rapid economic expansion is unlikely to produce the sort of growth rates we saw in the early 1990s. In the corporate world, researchers are working on ways to turn computing power into a commodity in which clusters of servers are used to sell computing power on demand, sort of the network computer idea on steroids. And eventually someone will design a Web appliance that will turn consumers' heads.

Still, the value proposition of the PC—good enough, really cheap—will make it hard to displace. I won't be surprised if 20 years from now, offices and schools are full of Pentium 15 PCs running Windows 2020.

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IBM PC

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1991

COMPAQ 486

PROCESSOR:

Intel 80486,

33 MHz

120 MB

hard drive

\$2,300



2001

DELL DIMENSION

PROCESSOR:

Intel Pentium 4,

1.3 GHz

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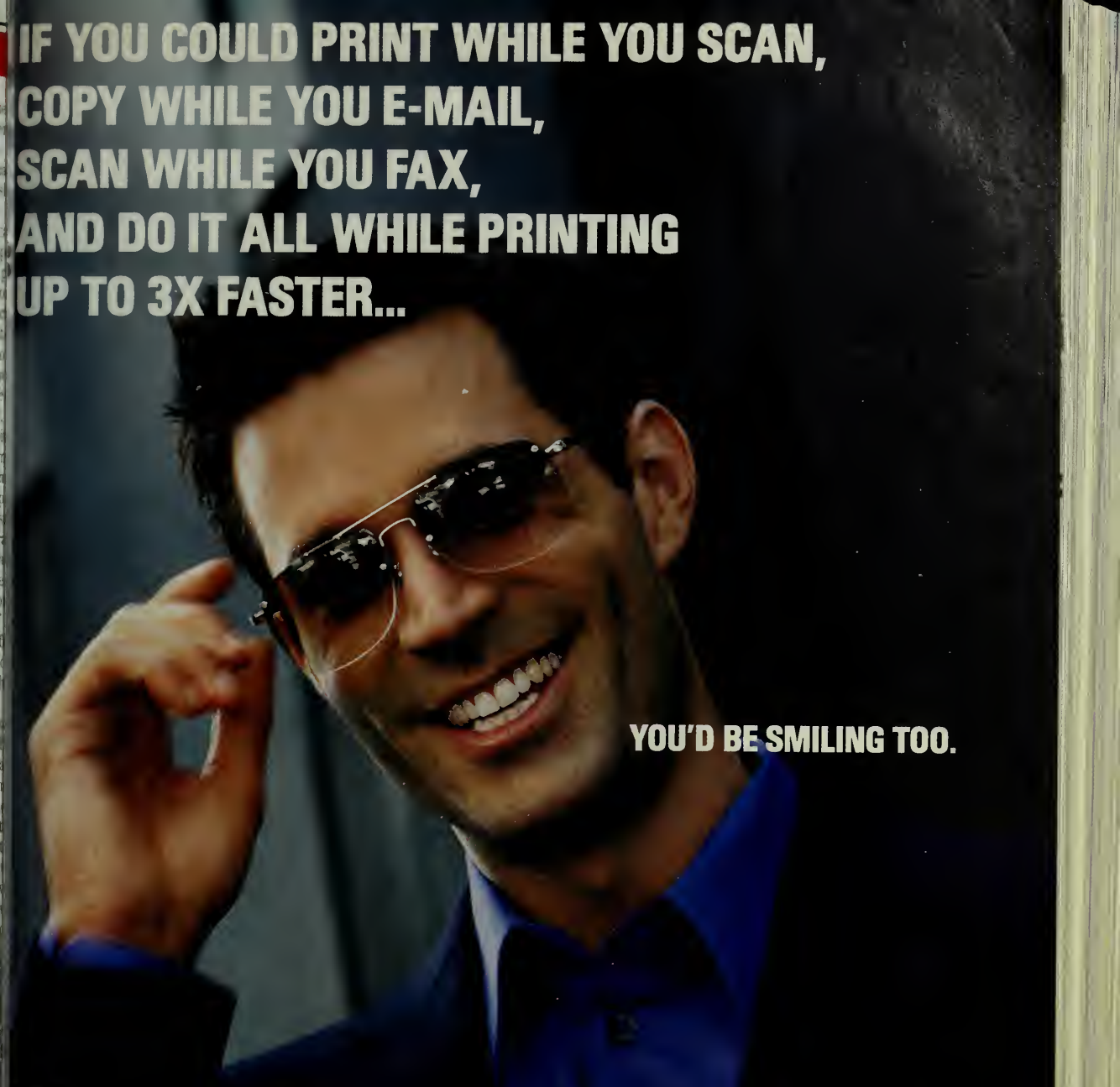
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BY ROBERT KUTTNER

A GLOBAL MARKET ISN'T AS EASY AS IT LOOKS



CARGO:
Even trade
zealots must
see that
reality—an
influx of
Mexican
trucks, an
exodus of
stem-cell
research—
can trip up
ideology

Globalization turns out to be a double-edged sword. Not only is Yankee capitalism influencing the world; the world is constraining the U.S. Whether you find that result congenial depends on the particulars.

By promoting the idea that the world is one big happy free market, American policymakers assume that other countries will follow U.S. rules. Indeed, a huge amount of diplomatic effort goes to produce that result. What happens when other nations have their own ideas?

Consider three recent cases. President Bush, with one eye on the Religious Right, decided that only very limited stem-cell research will get federal research grants. His allies in Congress would go further and ban not just public funding but most private research using human embryos.

However, as so much else these days, science is global. Indeed, great American research universities and corporations have long been magnets for the world's best and the brightest. But if the U.S. starts restricting research in the name of somebody's idea of theology, the science will just go elsewhere.

SIDE EFFECT. In Britain, for example, there are no restrictions on stem-cell research; public funds are plentiful, and the products of the research will be widely available to scientists. In the U.S., by contrast, a side effect of Bush's edict is that nearly all new research on stem cells will be corporate and proprietary. Researchers seeking access to breakthrough technologies and new colonies of stem cells will have to license them from the patent holders. This process can only slow down research and make it more expensive in the long run.

Guess which climate appeals to most scientists? Even before Bush's decision, several companies were exploring moves to Britain or partnerships with British enterprises. Roger Pedersen, a leading stem-cell researcher at the University of California at San Francisco, had announced plans to relocate to Britain. Bush's decision, based on the religious belief that an embryo in a petri dish is a human being, will not spare a single "life"; it will just drive science offshore.

Or consider the issue of drug pricing. Washington, siding with drugmakers, considers life-saving drugs to be commercial products; they are intellectual property. Much of the rest of the world considers them social goods. U.S. industry tried, and failed, to hold the line on exorbitant prices for AIDS drugs in Africa and

Brazil. Now, battered by global public opinion and political pressure in the U.S., and consumers who can buy drugs more cheaply abroad, drugmakers are under the gun to lower prices at home as well.

Finally, take the controversy over Mexican trucks. The U.S. has stringent standards for long-haul trucking. Under NAFTA, Mexico—despite its weaker standards—may send trucks across the Rio Grande. During the Clinton administration, U.S. policy ignored NAFTA and restricted Mexican trucks to a narrow border. President Bush wants to give the trucks free access to North America. Liberal lawmakers are pressing for border inspections so that Mexican trucks, just like Mexican lettuce, will meet U.S. safety standards. The Administration says that violates free trade.

Well, of course it does, and deservedly. As Americans, we make countless regulatory decisions—about the wages we pay, the air we breathe, the water we drink, the highway we travel, and, if President Bush has his way, the way we treat human embryos. We constantly limit domestic commerce to protect intellectual property rights, to promote cleaner water, and to keep abuses to a minimum in banking and the sale of securities.

SAME BOAT. Globalization of commerce doesn't make these policy issues moot, it just makes them more complicated. We still must choose what kind of society we want. Whether globalization seems a liberation or an assault depends on whose ox is gored.

Liberals may be appalled (and businesspeople pleased) when the effect is the erosion of unwon labor, environmental, or safety standards. Then, however, the corporate or religious community is outraged when globalization undermines cherished notions of intellectual property or human experimentation. Without rules, we must port foreign norms along with foreign products.

The particulars of how domestic society will change due to globalization are subtle and intricate. They must be engaged case by case. In some cases, we may need to negotiate new, common global rules. In others, we may insist on U.S. standards as the condition of foreign entry to our market.

The details are as inherently political as the problems are complex. The real simpletons are those who naively claim that all the U.S. needs to do as a society is sweep the rulemakers aside and let the markets make the decisions. Life is that easy only in economics textbooks.

Robert Kuttner is co-editor of *The American Prospect* and author of *Everything for Sale*.

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BY GENE KORETZ

TROPICS OF POVERTY

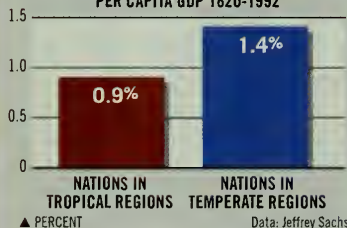
Ecological woes impede progress

A common view is that the best way to reduce the wide gap in living standards between the world's rich and poor nations is for the latter to implement market reforms fostering economic growth. While he doesn't reject such advice, economist Jeffrey Sachs of Harvard University thinks it ignores a pertinent fact: the pervasive impact of climate on economic development.

As Sachs stresses in a new study, tropical economies are almost all poor, while those in temperate zones are gen-

ECONOMIES BLOSSOM IN COOLER CLIMATES

AVERAGE ANNUAL GROWTH OF PER CAPITA GDP 1820-1992



erally rich. Of 30 nations classified by the World Bank as high-income, only two—Hong Kong and Singapore—are located in steamy climates. In 1992, output per capita in temperate nations averaged more than four times the level in tropical ones.

The economic gap wasn't always so large. Back in 1820, notes Sachs, per capita output in tropical regions lagged output in temperate zones by only 30%. The sluggish growth of tropical economies since then is what has created the current disparity. The critical question is: What has held these countries back?

Claims that colonialism is mainly responsible or that modern growth is linked to a capitalism rooted in European culture are belied by the woes of tropical countries that escaped colonization and by the rise of Asian powerhouses such as Japan and Korea, argues Sachs. The one explanation that holds up best is the impact of climate, which is found even in large nations where temperate regions are invariably wealthier than warmer ones.

As Sachs sees it, tropical regions face

two related major ecological handicaps: low agricultural productivity and a high burden of disease. Tropical soils are typically depleted by the effects of heavy rainfall, for example, and tropical crops are beset by pests and parasites that thrive in hot climates without winter frosts. Similarly, warm climates favor the transmission of many tropical diseases that are borne by insects and bacteria.

Compounding these problems, many technical advances in farming and health care developed for application in temperate regions are not readily transferable to tropical areas. Over time, the rapid pace of temperate-region innovation and the lack of such innovation in the tropics has widened the zone's lead, so that temperate-zone grain productivity per acre today is 50% higher than in the tropics, while infant mortality adjusted for income levels is 52% lower.

The upshot: Most tropical nations remain mired in poverty. Poor agricultural productivity results in poor nutrition—which compounds medical and social ills. Many couples have lots of children in the hopes that some will survive. High fertility, in turn, strains resources and lowers per-child investments.

Is there a way out? Sachs points to such success stories as Hong Kong, Singapore, and Taiwan, which acted forcefully to control disease and which diversified their economies away from agriculture toward export-oriented manufacturing. But he notes that many tropical nations, especially in sub-Saharan Africa, lack resources to tackle their massive agricultural and health woes.

What such nations desperately need, he says, is assistance in developing and applying technologies aimed at solving these ecologically based problems.

GIANT STRIDES FOR U.S. BLACKS

Affluence spurs flight to the 'burbs

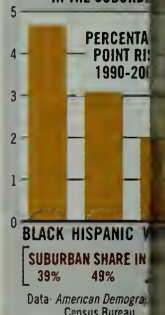
The economic boom of the late 1990s has had a big impact on the fortunes of African American families. According to an analysis of last year's Current Population Survey in the July issue of *American Demographics*, some 51% of black married-couple households had incomes of \$50,000 or more, up from 47% in 1999. And the Census Bureau reported that a record 17% of blacks aged 25 and over held college degrees, compared with 15% the year before.

This newfound prosperity has sparked

a black exodus from the central cities. Between 1980 and 1990, the share of blacks living in the suburbs jumped from 34% to 39%, says the magazine. (Meanwhile, the share of whites living in the suburbs rose by only two percentage points, and that of Hispanics by just three points.) On average, black suburban households had median incomes 44% higher than those of their city brethren, and some 10% had incomes of at least \$100,000.

SUBURBAN SUM

FAMILIES LIVING IN THE SUBURBS



WHY THEY CALL A 'TIDY SUM'

Neatness helps to predict success

Those familiar with psychoanalytic theory may recall the notion of "anal personality," which is characterized by traits supposedly derived from strict toilet training during infancy. People with anal personalities are typically described as neat, clean, and highly organized—with a particular penchant for saving and making money.

What brings this to mind is a study in the *American Economic Review* by Rachel Dunifon of the University of Michigan, Greg J. Duncan of Northwestern University, and Jean Brooks-Gunn of Columbia University. The authors are concerned with certain noncognitive personality traits and all that affect economic success. They theorize that people with an ability to maintain order and efficiency in their lives—reflected in the cleanliness of their homes—should do well in job markets and raise children who are more successful in school and their future careers.

To test this idea, the study drew on survey data following a sample of families over several decades. Adjusted for such factors as socioeconomic status, education, and cognitive ability, the results indicate that the cleaner people's homes were (as rated by interviewers), the higher their earnings were 25 years later. And kids from cleaner homes tended to go further in school and to earn more in their future jobs.

Thus, the findings justify the study's title: "As Ye Sweep, So Shall Ye Reap."

JAMES C. COOPER & KATHLEEN MADIGAN

HIS RECOVERY INSURANCE S LOW RISK—AND LOW COST

With inflation tame, it's safer to cut rates too much than too little

U.S. ECONOMY

The Federal Reserve took out some recovery insurance on Aug. 21 when it cut interest rates for the seventh time this year. And why not? The price was too cheap to pass up.

Despite some signs that the worst is over, the economy's first-half weakness has seeped into the third quarter. The frailty makes for a mixed bag of data. Output cuts by tech producers are getting larger, but sales at old-line manufacturers are narrowing. The index of leading indicators, those that foreshadow the economy's path, has now risen for four months in a row, while retail sales and housing continue to hold up surprisingly well (charts). But consumers aren't spending as vigorously as they did in 1999 and 2000, and exports are losing more ground.

ONE SIGN THAT THE WORST IS OVER



and has been sustained." Back on June 27, when the Fed last cut rates, consumer spending was characterized as "weak." Without any assurance that the end of the tunnel was in sight, investors pushed the Dow Jones industrial average down 146 points on Aug. 21, while the Nasdaq was off 50 points.

The Fed's caution means another cut at the Oct. 2 meeting cannot be ruled out, and upcoming data, especially on employment, capital-goods orders, and the purchasing managers' survey will be key in determining the Fed's next move. Luckily, policymakers can afford to be on the side of accommodation because falling prices for energy and tech gear are keeping inflation tame.

LOWLY CONSUMER PRICES made that point loudly. Thanks to a 5.6% plunge in energy prices, the consumer price index fell 0.3% from June. Replicating a seasonal trend, the yearly inflation rate, which had been held up by costlier gasoline and natural gas since early 2000, fell from 3.2% in June to 2.7% in July, the low-

est rate since January, 2000. Some further decline in energy prices is likely in August as well.

The core CPI, which excludes energy and food, rose a modest 0.2% from June to July, even though tobacco prices jumped 4.8%. Excluding that surge, which relates more to legal than market influences, the core CPI increased a scant 0.1%, and yearly core inflation is 2.7%—about where it has been all year.

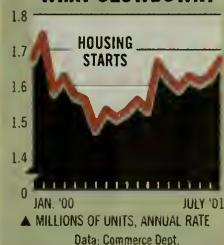
In addition, the Fed's preferred measure of inflation, the price deflator for consumer spending, looks even more favorable. Through June, core inflation using that price gauge was 1.8%, nearly a percentage point lower than the core CPI, and the rate is down slightly over the past year. The dissimilarities in the indexes partly reflect different treatment of housing and medical care, which have been adding to CPI inflation over the past year.

Lower inflation, especially in the energy and technology sectors, figures prominently in the recovery outlook as well as for policy. For businesses, lower fuel costs and cheaper productivity-building machinery hold down expenses and boost profits. For consumers, low inflation increases purchasing power at a time when nearly 64% of the population is employed, one of the highest levels in the postwar era. For June and July, real weekly earnings of production workers scored the largest two-month gain in almost four years.

STURDY INCOME GAINS are a big reason why consumers continue to lift their spending at a rate that will keep the economy afloat. The pace of shopping at the beginning of the third quarter about matched that of the second quarter. Retail sales in July were unchanged from June, and excluding lower auto sales they rose 0.2%. However, the month's 11% dive in gasoline prices pushed receipts at gas stations down by a record 4.2%.

The sales drop at the gas pump concealed strong increases at other stores, including those that sell electronics, clothing, health products, and general merchandise, as well as at restaurants. The July strength means consumer spending, as it is counted in the gross domestic product data, is off to a solid start this quarter. Real outlays may be growing at an annual rate

HOUSING: SLOWDOWN? WHAT SLOWDOWN?



slightly faster than the second quarter's 2.1% pace.

The July sales gains were in areas that would be expected to be affected by tax-rebate spending. Still, only a small portion of those checks hit consumers' mailboxes that month, suggesting the boost to August sales will be even greater. Also, since the Commerce Dept. bases its preliminary monthly data on an incomplete survey, July sales could be revised upward.

Consumers will continue to spend as long as they are confident about the future. That's why the pickup in consumer sentiment in early August, according to the University of Michigan's survey, is a good omen for the outlook. And perhaps a more telling measure of confidence is consumers' willingness to commit their future resources to buy a new home. Housing starts rose 2.8% in July to the highest level since January, 2000. Moreover, builders are increasingly upbeat. In August, the housing market index compiled by the National Association of Home Builders jumped to 62, from 56 in July—as high as it has been since November.

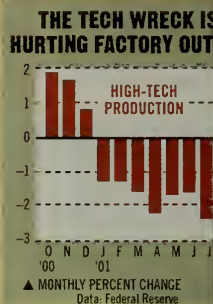
ONE AREA THE FED has a close eye on is manufacturing. That's where the economy's troubles began last year, and the Fed will require some concrete signs of improvement there—for both production and profits—before it can stop its rate-cutting regimen.

On that front, the July data on industrial activity offered both hope and gloom. Overall industrial produc-

tion fell 0.1%, and manufacturing output alone was down from June. But outside of technology industries, manufacturing output rose 0.2%, buoyed by a 4.7% jump in auto output. It was the first such increase since September. Tech-sector production, however, plunged 2.4%, the largest drop of the year (chart).

The firmer tone of production outside of tech suggests that the deepest part of the inventory reductions are now past. If so, it will provide a lift for production and economic growth in the coming months. Stock levels of manufacturers, wholesalers, and retailers fell 0.4% in June, the fifth monthly decline in a row. The problem: The ratio of inventories to sales for tech-equipment manufacturers is still rising, suggesting that stockpiles in the sector are still way out of line with demand.

The tech sector will continue to hold back manufacturing activity for some time to come. With the economy still facing dangers, the Fed may not be finished cutting rates. And with the inflation outlook improving, the risk of overeasing is one that policymakers can afford to take. Policymakers would prefer to cut rates once more rather than risk an end to the expansion.



TAIWAN

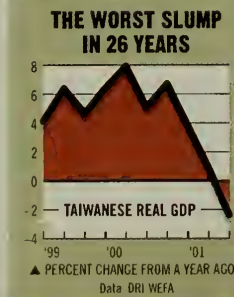
ONE MORE ROAR FALLS QUIET

Another Asian Tiger has become as meek as a mouse.

In the second quarter, Taiwan's real gross domestic product fell 2.4% below its year-ago level, the worst performance in 26 years (chart). Exports, including high-tech electronics, tumbled as global demand dried up. In particular, U.S. trade data show the U.S. spent 10% less for Taiwanese goods in the first half of 2001 compared with the same period a year ago.

Foreign demand, while a crucial drag, is not the only culprit. Consumer spending was up by just 1% last quarter, as households grappled with a record-high jobless rate of 4.6%. And companies

are cutting inventories this year, another drain on economic growth. The government said real GDP is on track to shrink by 2.5% in the third quarter. In 2000, real GDP surged 5.9%.



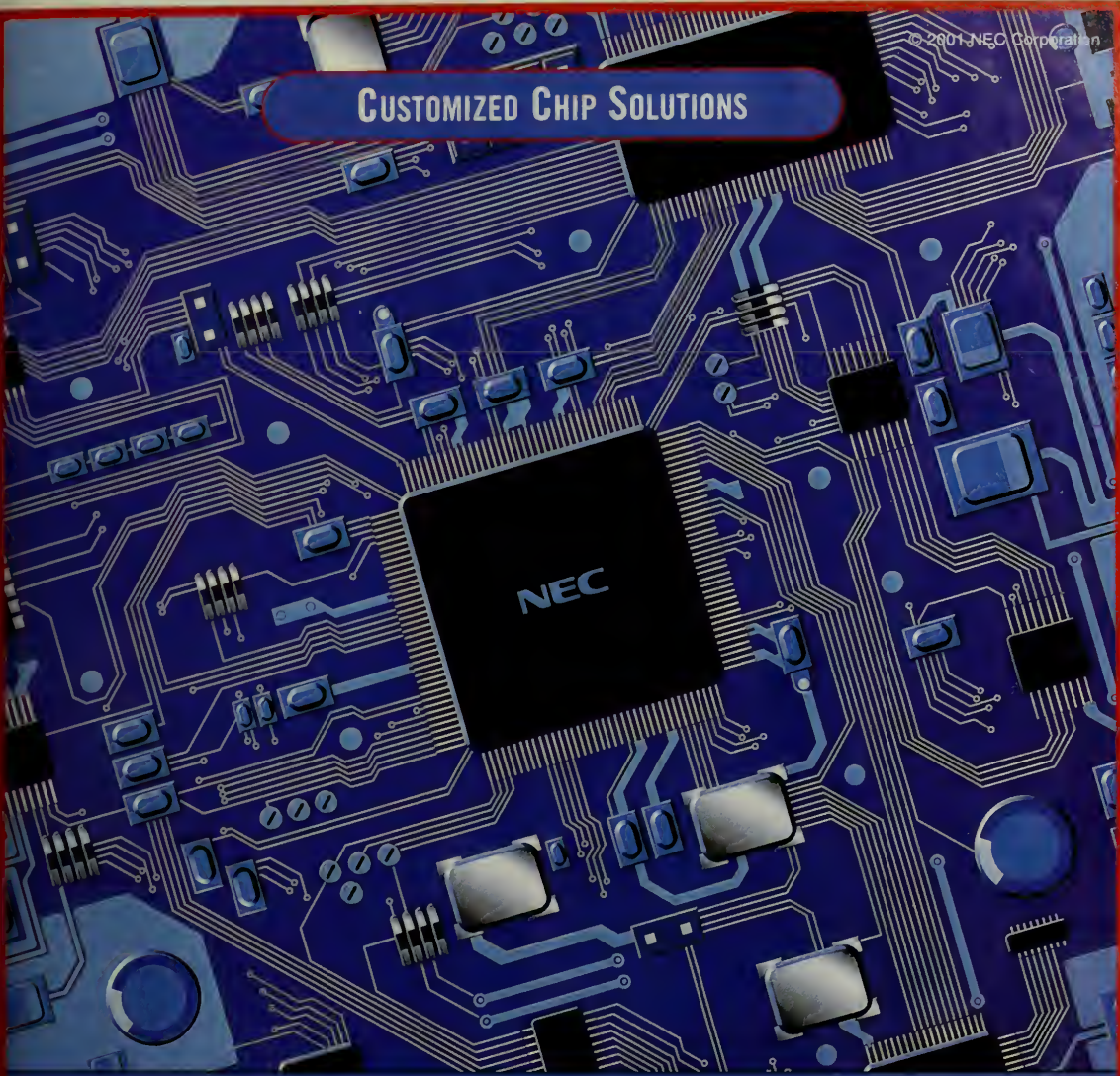
The economic weakness came on suddenly and has exposed some cracks in the financial system. The stock market is down about 8% so far this year, and banks are saddled with a rising number of nonperforming loans. Standard & Poor's estimates 10% of Taiwan's bank loans are delinquent.

Immediately after the dismal GDP data were released, the central bank cut its target rate from 3.5% to 3.25%, the fifth cut this

year. The move might help the corporate debt situation, but it also means further weakness for the Taiwanese dollar.

The GDP decline means Taiwan joins the list of east Asian economies that were once roaring and are now squeaking by. Singapore is officially in recession, Hong Kong's economy slowed dramatically this spring, and South Korea on Aug. 21 said its second quarter economic performance was the worst since late 1998.

Taiwan's economic troubles have pushed the tiny island nation to forge even closer ties with China. On Aug. 20, the government announced plans to tap China's economic rise and perhaps loosen restrictions on trade and investment in China. Unfortunately, those plans are long-term goals and will do little to help the current wo-



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GREENSPAN IN A BIND

His efforts to revive the economy have failed to do the trick

Back in January, when Federal Reserve Chairman Alan Greenspan launched the central bank on its most aggressive interest-rate-cutting campaign in nearly 20 years, the decision was in many ways an easy one. The high-flying New Economy had ground to a halt. Stock prices were plunging. And consumers were growing more worried by the day. What was needed, clearly, was a heavy dose of monetary medicine to stave off a recession. Dr. Greenspan provided that, cutting rates seven times in eight months.

But now, a full three percentage points of rate reductions later, Greenspan finds himself in a bind. His all-out effort to turn the economy around so far has not done the trick. The U.S. is still teetering on the edge of a recession, and deflationary forces are mounting. The stagnant economy is also taking its toll on corporate profits. On top of all that, the once-ballooning federal budget surplus has collapsed, a victim of the Bush tax cuts and a slowing economy. On Aug. 22, the White House said that this fiscal year's non-Social Security surplus would fall to less than \$2 billion—down from a \$125 billion surplus projected in the



Bush Administration's April budget request. "There are a lot of negative things around," says W. James Farrell, CEO of Illinois Tool Works, a diversified manufacturer in Glenview. "I don't think the odds are good that the economy's going to go back up."

The trouble, experts say, is that the Fed is increasingly constrained in how

much more it can do to combat the economic weakness. Another round of rapid-fire rate cuts could turn what far has been a welcome, gentle fix of the dollar into a full-scale rout. "If the dollar continues to weaken, the Fed's hands could be tied when it comes to further easing," says Michael Waller, senior economist at Standard & Poor's, which like *BusinessWeek* is a unit of The McGraw-Hill Companies.

Further aggressive monetary easing also runs the risk of pumping up aban-

frothy house prices, setting the stage for a damaging downturn later (page 34). Housing prices nationwide are rising at a more than 8% annual rate, with some cities, such as Washington, registering double-digit gains. "Home buyers are taking note, preferring to invest in housing rather than in the declining stock market," says Bruce S.

builder in Walnut Creek, Calif. It's sentiment such as this that has analysts worried. They fret that illience in the housing market may lead to too-loose credit standards by mortgage lenders. The result, these analysts say: House prices have reached bubble status in some parts of the U.S.—a worrying trend that would only be exacerbated by bigger Fed rate cuts. **CEO's.** Faced with the conflicting pressures, Greenspan has ratcheted back the size and frequency of the Fed's rate cuts. The central bank's quarter-over reduction on Aug. 21 was its smallest size cut in three months, following five rapid-fire reductions of a half-point each earlier in the year. A statement announcing its action, the central bank signaled that it might raise rates again but was in no hurry to do so. Wall Street turned thumbs down this scenario, sending stocks into a downward spiral before they recovered slightly the next day.

Investors are worried that the Fed's more languorous approach to rate cuts could undermine the much-hoped-for economic recovery before it fully gets under way. With the long-awaited second-half rebound proving elusive so far, business leaders and investors are getting antsy about a continuing disinflationary business downturn that's eating away at corporate profits. With their selling prices under pressure from fierce competition and a dearth of demand, CEOs are taking another look at cutting costs and paring payrolls. Investors, meanwhile, are reassessing their portfolios and dumping shares. If the Fed is not careful, this double-barreled barrage of bad news could crimp the confidence of consumers, the one sector of the economy that has stayed strong and

Rapids (Mich.) office-furniture maker, and 1,700 layoffs by New York media giant AOL Time Warner Inc.

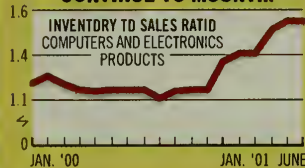
But it's not just costs that are being cut. Prices are being slashed, too. The competition is particularly fierce in high tech, where falling capital-goods orders and mounting inventories have sparked an all-out price war in computers and semiconductors. As a sign of the mounting deflationary forces worldwide, U.S. import prices fell 1.6% in July, their largest one-month decline in 8½ years.

The profit pinch has not gone unnoticed on Wall Street, and analysts are busy marking down their earnings forecasts as a result. According to Thomson Financial's Joseph S. Kalinowski, Wall Street analysts on average expect operating earnings of companies in the Standard & Poor's 500-stock index to fall 13.8% in the third quarter and 1.4% in the fourth. Just two months earlier, those same analysts had been projecting a small decline of 3.5% in the third quarter followed by a rise of 8% in the fourth. Even Wall Street's most fervent bulls are turning more cautious. In a note to clients on Aug. 21, Abby Joseph Cohen, chief investment strategist at Goldman, Sachs & Co., conceded that she had been too optimistic about this year's earnings,

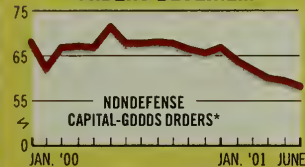
SLIP-SLIDING AWAY

Seven cuts and 300 basis points later, Fed strategy has so far failed to produce results.

AS TECH INVENTORIES CONTINUE TO MOUNT...

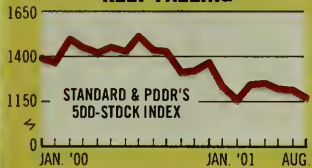


...CAPITAL-GOODS ORDERS DECLINE...



▲ BILLIONS OF DOLLARS
*EXCLUDING AIRCRAFT, SEASONALLY ADJUSTED

...AND STOCKS KEEP FALLING



Data: Census Bureau, Bloomberg Financial Markets

PRESENT DANGER Experts say the Federal Reserve's range of options for combating the weakness may be shrinking

the U.S. out of recession. Almost no industry is immune to the need to chop costs. On Aug. 17, Ford Motor Co. said it would eliminate as many as 5,000 salaried employees by year-end and warned of more cost-cutting to come (page 35). On Aug. 21, that was followed by news of up to 1,100 cuts at Steelcase Inc., the Grand

but said she still sees shares rising by the end of 2001.

Judging by the action on Wall Street, Cohen is in a shrinking minority. The technology-laden Nasdaq index has plunged by nearly 15% in the past 1½ months, while the more broadly based S&P 500 has dropped 5%. "The conditions are in place to test the April lows,"

says market strategist Robert Stovall of Prudential Securities.

So far, consumer confidence and, more importantly, consumer spending have held up, even in the face of rising layoff announcements and sliding stock prices. But there are signs that consumers might be about to become more cautious. A University of Michigan poll of consumers in early August found that just 18% of those expecting a tax rebate planned to spend it. The remainder intended to stash the money away in savings or use it to pay down debt. "The tax-rebate impact will be very minimal," says Kurt Barnard, president of *Barnard's Retail Trend Report*. "People are going to buy what they need."

With fiscal policy constrained, the onus is on the Fed to do even more to fire up the moribund economy. But there are clearly limits

on what the central bank is able—or willing—to do. While Greenspan has brushed aside concerns that the rush to cut rates could ignite inflation next year, some of his fellow policymakers are not so upbeat. With unemployment still near record low levels despite the economy's weakness, the Fed hawks are worried that price pressures could build up next year if the Fed eases too much now.

After slashing rates so sharply in such a short period of time, Greenspan could be forgiven for thinking that his job of piloting a takeoff for the economy was about to become easier. But no such luck. With the

U.S. perched precariously between recession and recovery, Greenspan faces more difficult decisions in the days ahead. Let's hope he gets things right. The fate of the New Economy depends on it.

By Rich Miller in Washington with Stephanie Anderson Forest in Dallas, Michael Arndt in Chicago, and bureau reports

BANKING

A HOUSING COLLAPSE COULD WOUND THE BANKS

Spreading the risk won't save lenders if the price bubble bursts

It has been a tough year for banks, what with profits being hit by corporate loan defaults, junk-bond losses, and restructuring charges. The next knock may come from the one area of the economy that has long seemed like a safe haven: housing. Thanks to a hyper-efficient home loan industry, the amount of outstanding home mortgage debt has skyrocketed more than 40% in the past five years, to \$5.28 trillion, according to the Federal Reserve. Not only is homeownership at record levels, but consumers have also opted to refinance into larger and larger loans.

There is no sign that banks are putting on the brakes either, despite signs of a crumbling economy. The four biggest lenders nearly tripled mortgage originations in the first six months of 2001. In fact, profits from home loans have helped banks offset weak commercial and investment bank business.

Some now say the home loan factory has worked too well by creating overvalued home prices. Critics worry that, just as in the savings and loan crisis of the early 1990s, financial institutions will be hit hard if real estate values fall and loan delinquencies or defaults pile up. A decade ago, thrifts got themselves into trouble because they made residential and commercial real estate loans for inflated amounts to borrowers who could not pay. A government bailout of the failing thrift industry ended up costing taxpayers \$200 billion.

At first glance, banks seem to have wised up since then. In the early 1990s,

they held on to most of their real estate loans and suffered accordingly when the defaults piled up. Today, most lending institutions either sell off their loans to government-sponsored Fannie Mae and Freddie Mac or package them as mortgage-backed securities. These securities

are then actively traded on Wall Street between corporations, foreign investors, and insurance funds. In 2000, there were more than \$3 trillion in mortgage-backed securities outstanding.

But all that doesn't get the banks totally off the hook. They are still required to hold on to some or all of the risk for loans sold to

Fannie Mae and Freddie Mac. In 2000, banks were responsible for losses of about 20% of the \$2.5 trillion loan portfolio held by Fannie and Freddie.

In addition, bankers say privately that Fannie Mae and Freddie Mac sometimes force them to take back poorly performing loans, even when they have sold them outright. Michael Quinn, a Fannie Mae senior vice-president, acknowledges that "when loans go bad, we look at why they went bad." He says Fannie Mae does occasionally charge them back to the lender, but such instances are rare.

That could change. A deeper downturn and a concurrent rise in mortgage delinquencies and defaults could be disastrous for banks that sell loans to Fannie and Freddie should those organizations require banks to eat their losses. "Lenders are scared to

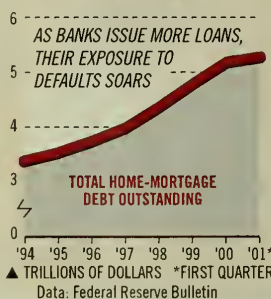
death," says Christine Clifford, partner at Wholesale Access, a risk assessment firm. "Every loan there is a loss." Fannie and Freddie are going to them to buy it back."

"RAW DEAL" The consolidation of bank and investment banks in recent years may also have raised their exposure when the housing market goes bust. Many of the largest home lenders—including Chase Manhattan Mortgage Corp., Citigroup Mortgage—are now subsidiaries of bank holding companies. Rather than selling loans outright to investment banks, these lenders transfer the loans—and the risk—to other part of their holding companies. "As these loan pools go bad and securities start underperforming, investors are going to go back to the investment banks that sold them and say: 'You gave me a raw deal, and I want you to buy it back,'" predicts Charles Peak, partner at Ventana Capital.

Some housing experts say there is a question home prices are greatly inflated. "The hard part is figuring out whether the bubble is going to burst," says Ryan of Fulcrum Global Partners, based in New York. "When all the Internet stocks were going up 40 points a day in 1999, it was clear it was a bubble, but you went out and shorted them and you would've lost your shirt." Mortgage lenders can only pray the air goes out of this bubble a lot more slowly.

By Heather Timmons in New York

RISKY BUSINESS?



COMMENTARY

By Kathleen Kerwin

FORD: LOOK TO THE LINEUP, GUYS



BREAD AND BUTTER: Full-size pickups are best-sellers but need revamping

says Sean McAlinden of the Center for Automotive Research in Ann Arbor, Mich. "Better to go back to the drawing board," he says, "and design better cars and trucks."

How to start? First, concentrate on revamping bread-and-butter vehicles like the F-150 full-size pickup truck. Ford has already unwisely delayed the latest version of the F-150, its U.S. best-seller. "Ford is getting destroyed by competition from General Motors," says Wesley R. Brown of auto consultant Nextrend Inc. "The last thing they need to be doing is delaying product."

With a lineup in place, Scheele should next help Ford's engineers and product planners to devise a system to design cars that can be built quickly, cheaply, and defect-free. Good product development can cut costs. Ford could save a bundle, for instance, by sharing mundane parts—everything from fuel pumps to steering columns—among its vehicles.

Making product development Job One has worked for other auto makers. When

Renault's Carlos Ghosn started overhauling Nissan Motor Co. in 1999, he declared everything at the auto maker fair game—except product development. "That was gospel," says Michael Robinet, managing director of auto consultant CSM Forecasting. "That's what Ford needs to do." Ford could also learn from Daimler-Chrysler's months of soul-searching on how to turn around its Chrysler Group. Chrysler Group CEO Dieter Zetsche is revamping the company's once-stellar product-development teams to boost quality and cut costs.

Scheele's big headache, however, will be funding new vehicles. Ford is cash-strapped thanks to acquisitions—Volvo and Land Rover—the Firestone tire recalls, and share buybacks. So the pressure on Scheele to delay new products will be intense, especially since other cost-cutting options are problematic. With its U.S. vehicle sales down 12% through July, Ford does have excess capacity. But labor contracts make plant closings difficult. More white-collar layoffs will only further erode morale. And Ford has already hiked its price-cut demands to suppliers to 6% from 4%, pushing them to their limits.

Ultimately, Ford can't cost-cut its way out of trouble. That won't lure buyers into the showrooms. The answer is as simple as it has always been. Just make better cars.

With Joann Muller in Detroit



SCHEELE

FIXING FORD

Ford needs to:

FIND new ways to root out defects and delays

REGAIN dominance in truck market

FIGURE out how to win back young buyers

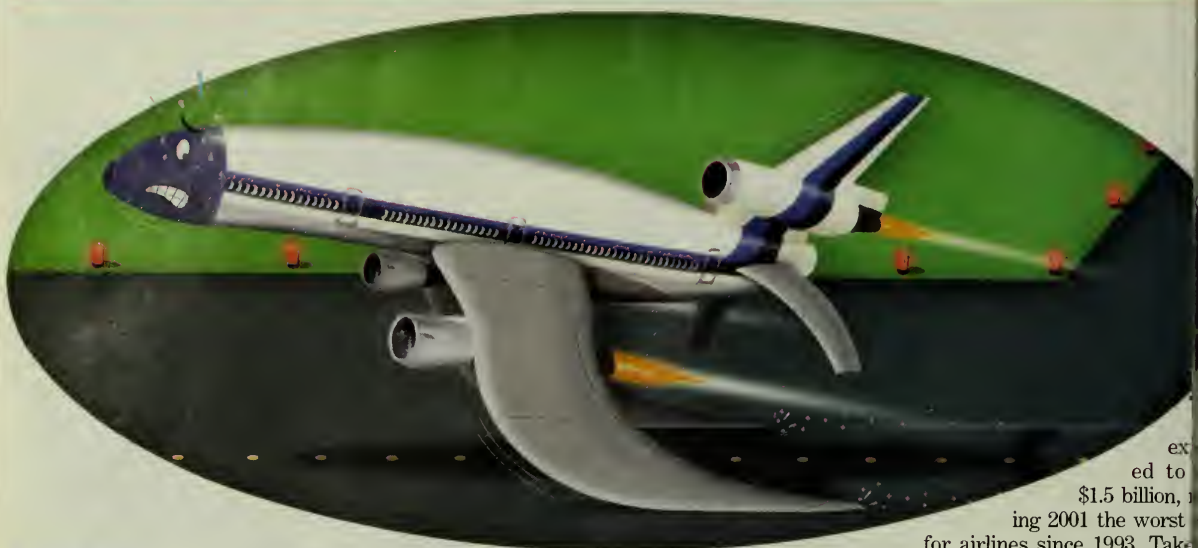
Call it tossing Wall Street a bone. Ford Motor Co. said Aug. 17 that it will shed 5,000 salaried employees. The severance costs, along with other write-offs, will shave \$900 million from second-half profits. The move was designed to show investors that Ford is serious about tackling its problems while buying the carmaker time to figure out its restructuring game plan.

That unenviable task falls to Nick Scheele, 57, Ford's new chief of North American operations. He comes to the U.S. after whipping Ford's Jaguar division into shape and starting a promising overhaul of Ford of Europe. But investors are alarmed by slumping U.S. sales and profits, a possible dividend cut, a cash position that has fallen to \$4 billion from \$15 billion in a year, and now, the possibility of a credit downgrade. So Wall Street wants the 35-year Ford veteran to make \$5 billion in cuts and is already clamoring for plant closings, more layoffs, and more supplier price squeezes.

Scheele has yet to say what he will do. But Ford CFO I. Martin Inglis says "nothing is off limits."

DO NOT CLOSE PLANTS. One thing should be, however: cuts in funding or new car and truck development. Inglis doesn't want to do that. But it will be tempting to dip into the estimated \$10 billion set aside for product development. Scheele should

make a gutsy call, declaring product development sacrosanct. That's the key to Ford's turnaround. New cars and trucks are Ford's best hope of shoring up sales, especially among young buyers the company hopes to turn into repeat customers. Higher sales will also reverse the declining market share that leads to continual downsizing. And the product-development process is where Ford can boost productivity and car quality. Forget about closing plants,



AIRLINES

SUDDENLY, CARRIERS CAN'T GET OFF THE GROUND

Slumping business and vacationer demand proves weighty

Taking a midday flight on Northwest Airlines? Better pack a lunch. The nation's No. 4 carrier is dropping meal service on flights of less than 2 hours and 15 minutes. Starting Sept. 1, Northwest is also eliminating most special meals for coach-class passengers on domestic flights, including children's meals. The reason: Northwest Airlines Corp. is struggling to reverse losses that totaled \$226 million in the first six months of 2001. The airline is firing workers, suspending executive bonuses, closing reservations call-centers, and retiring planes early. But even those tried-and-true fixes haven't been enough. By cutting back on meals, executives figure the airline will save another \$1 million a month. "We felt this is the prudent thing to do," says President Douglas M. Steenland.

Only a year ago, Northwest was flying high along with most U.S. airlines. Business travel, the lifeblood of the airlines, had never been stronger. Consumers, flush from the economy's boom, were also taking wing. But with the economy near recession, business flyers have cut back,

plunging the industry into its worst financial crunch in almost a decade. The slowdown has already taken its toll. On Aug. 13, citing a "calamitous" decline in business traffic, Midway Airlines Corp. declared bankruptcy.

"BASKET CASE." There isn't much hope for improvement anytime soon. Higher wages and still-steep fuel prices, plus a seasonal drop-off in vacation travel, mean the skies will remain dark for much of the industry in the months ahead. The business, says David E. Swierenga, chief economist of the Air Transport Assn., "is a basket case."

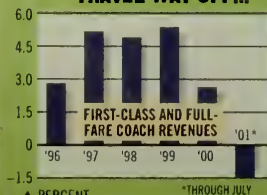
It has been some U-turn. Industry profits totaled \$2.6 billion in 2000. This year, the nation's 10 biggest airlines are

expected to lose \$1.5 billion, making 2001 the worst year for airlines since 1993. Taken together, profits by Continental Airlines Inc., which benefited from the energy boom, and perennially profitable Southwest Airlines Co., and the industry's losses would total \$2.2 billion.

Business travel is crucial for the airlines because they derive the bulk of their earnings from high-margin first-class and last-minute tickets, which typically cost two to three times as much as coach fares. These days, with corporate profits hitting the skids, businesses are putting the brakes on spending. So far, Systems Inc.'s cutbacks are typical. Before the tech downturn, the San Mateo (Calif.) software maker permitted its sales and marketing people to travel whenever they wanted. When it was stalled earlier this year, Chief Executive Thomas M. Siebel halved the company's travel budget, to \$18 million per quarter. "I said, 'I don't want you to travel anywhere other than to see a customer,'" says Gillette Co., where CEO James M. White has ordered all units to achieve "no overhead growth," many employees are now flying coach instead of business class to Europe. And at Staples Inc., "we're using a lot more teleconferencing than a few years ago," says President Ronald L. Sargent.

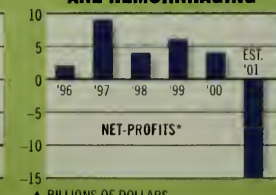
Travel to and from high-growth hot spots has been particularly hard hit. American Airlines Inc. says business traffic in Austin, Tex., Boston, and San Jose, Calif., is down 15% from a year earlier. At UAL Corp., parent of United Airlines, summer business bookings at San Francisco and Dallas have been down as much as 34% in some months. "People are cutting discretionary spending

WITH BUSINESS TRAVEL WAY OFF...



*THROUGH JULY
▲ PERCENT
*MAJOR, NATIONAL AND REGIONAL U.S. CARRIERS. THE NUMBER OF AIRLINES VARIES YEAR-TO-YEAR, DEPENDING ON STARTUPS AND FAILURES. IN 2000, 96 WERE REPRESENTED.

...AIRLINE PROFITS ARE HEMORRHAGING



▲ BILLIONS OF DOLLARS
Data: Air Transport Assn., Goldman Sachs & Co.

unfortunately flying fits into this category," says UAL President Rono J. Ta. UAL is forecast to lose \$985 million this year.

More bad news is on the horizon. Vacationers, previously lured by fare sales and cheap tickets, aren't filling as many seats as they did only a month ago. Once the summer ends, tourist traffic tends to dry up. Meanwhile, international traffic—another high-margin business—is also weakening, as the economies of Europe, Asia, and Latin America head south. "When the general economy catches a cold, the airline industry catches pneumonia," says analyst Kevin C. Murphy of Morgan Stanley-Dean Witter & Co.

Demand isn't the only problem. Fuel prices are inching higher, while wages are still climbing. Air Transport Statistics Administration figures labor expenses will be nearly \$52 billion in 2002, up 15% from the \$45.3 billion in 2000. He says airlines are now paying more for fuel than in 1999.

ACTION. To gain some altitude, the biggest airlines are casting off whatever they can. Almost all are reducing the number of flights they offer. Northwest is in its second round of layoffs this year, and plans to cut 1,625 of its 100,000 workers by year-end. American has lopped \$200 million from its capital budget this year and plans an additional \$700 million cut in 2002.

Most radical are restructuring efforts at money-losing US Airways and Delta Inc. Blocked by the Justice Department from selling itself to UAL, US Airways wants to remake itself into a lower-cost regional carrier. It plans to replace 60 big hubs with smaller regional ones that should be easier to fill and cheaper to fly.

Until, there are some signs of improvement. Rosenbluth International, a corporate travel agency, says that in the five-week period ended Aug. 17, corporate bookings were up as much as 18% for 18 of its 25 biggest accounts. A survey of 200 companies released Aug. 20 by the National Business Travel Assn. finds that 74% plan to do the same or more on travel next year compared with 2001. That, of course, wouldn't restore traffic to pre-down levels. Says Rosenbluth CEO F. Rosenbluth, "I don't think the outlook will be anywhere near as pessimistic as the decline was." Looks like business travelers may be forced to make do for a while, as the industry struggles to stay aloft.

by Michael Arndt in Chicago, with William Symonds in Boston, and bureaus

BUCKING THE ODDS, VEGAS IS STILL PACKING 'EM IN

With much of the travel industry in the doldrums, the world's gambling capital is getting a boost from an unlikely source—business travelers. Convention attendance in Las Vegas jumped 13.4%, to 2.4 million conventioners, in the first half of this year. "I just love the glitz and glamour and all of the shows," says Roy J. Erwin, 67, a health-care product distributor from Kansas City, Mo., recently in town for a two-day business conference.

He's not the only one. A confluence of economic and demographic shifts have put the onetime lair of Frank

as MGM's Bellagio and Sheldon Adelson's Venetian, were built with fancier rooms, nicer restaurants, and expanded meeting facilities. That's snaring convention dollars from such cities as Orlando and New York.

REALLY BIG SHOWS. True, Las Vegas has always had a lock on a number of large conventions. Businesspeople have to attend events ranging from Comdex to shoe conventions. "If you don't go to the big shows, people think you're struggling," says Christopher Watt, owner of the Aussie Dog Sheepskin Footwear Co. and a regular at Western Shoe Assn. shows in Las Vegas.

But Vegas has another card up its sleeve: It's cheap. A recent study by Bear, Stearns & Co. put Las Vegas at No. 9 among the 10 largest trade show destinations in terms of average hotel room rates. Meanwhile, Las Vegas ranked dead last in average meal cost.

The rest of the casino industry hasn't fared so well. While MGM's Las Vegas properties with large meeting facilities, like the Bellagio and The MGM Grand, enjoyed record profits in the second quarter, properties like the New York-New York Hotel & Casino, with relatively little meeting space, saw their profits slide. Furthermore, companies with more exposure

to riverboat gambling and smaller markets also reported disappointing numbers in that quarter.

There's a good chance, too, that Las Vegas may

BARGAIN

Low prices on fares, rooms, and meals are a big drawing card

Sinatra and Cher on a roll during lean times. And it isn't because vacationers want a stint with Lady Luck. Cheap lodgings and a shift away from family entertainment have made the capital of glam a top business stop. "Our conference and convention business is booming," says James J. Murren, president and chief financial officer of MGM Mirage Inc.

The boom follows years of something of an identity crisis for Vegas. The place flopped as a family destination during the early 1990s. So casino companies got back to selling glitz to business customers at the end of the decade. New hotels, such

eventually kill its golden goose. The Mandalay Resort Group is building a 1.8-million-square-foot convention center adjacent to its Mandalay Bay Hotel. And the Venetian is building a 1,000-room tower next to its Sands Expo Convention Center. "There's always a risk they are going to overbuild," says Thomas P. McIntyre, a money manager whose Dessauer and McIntyre Asset Management Inc. owns 1.5 million shares of Park Place Entertainment. For now, though, Las Vegas' bet on business travelers seems to be right on the money.

By Christopher Palmeri in Las Vegas

CONVENTION SPACE
NOW BEING BUILT
MAKES OVERSUPPLY
A CONCERN





TELECOM

THE SMALL FRY THAT ATE THE BOONIES

Tiny Alltel has been gobbling up rural phone companies

Alltel Corp. is a pipsqueak with a giant's appetite. With \$7.5 billion in revenue, the Little Rock-based phone company is small by the gargantuan standards of the telecom industry. But its father-and-son management team has spent \$12 billion over the past three years gobbling up scores of competitors. Now, Alltel is trying for its biggest meal yet, making a \$6.1 billion offer for CenturyTel Inc., a rural carrier in Monroe, La. That comes out to \$43 a share, a 40% premium over the trading price.

So far CenturyTel has rejected the Aug. 14 bid, convinced that its core local phone business is strong. It figures that selling off a struggling wireless unit is its best strategy. But Alltel wants the whole company. And if it prevails, Alltel will transform itself into an industry player—with a very particular niche. Alltel hopes to dominate small-town America, with 12 million customers and \$10 billion in revenue. In the emerging rural wireless market, it would have three times more subscribers than its closest competitor, U.S. Cellular. And its local-service reach would extend from

Alltel's strongholds across the South through to CenturyTel's networks in Indiana, Tennessee, and Michigan.

Other rural carriers are understandably wary of such a giant in their midst, and so are their big-city cousins. Huge wireless carriers like Verizon Communications and Cingular Wireless had expected that small towns would be easy pickings to fill out their national service footprints. An Alltel-CenturyTel merger would make sauntering into the boonies a lot more difficult. "It's smart of Alltel to make a big play now while the Bells are still just looking at the rural wireless market," says Nancy Kaplan, vice-president at industry consultant Adventis Corp.

Alltel's smarts have been in evidence for some time. The company has been regularly bettering its position while the industry as a whole deteriorated. Under Chairman Joe T. Ford's 14-year tenure, Alltel has made more

than 250 acquisitions. It has averaged an 18% return on equity over the past four years and has \$3 billion in aggregate cash flow.

Kaplan and other analysts believe Alltel will eventually become a irresistible target for wireless giant looking for quick entry into rural markets. But Alltel has

dent Scott T. Ford, the chairman's son, insists he plans to keep his company independent—up to a point. "If someone walked in with an offer that was a premium, I'd seal the exits," says Ford, only half-joking.

His reluctance to sell out is understandable: For the Fords, Alltel is much family as business. The son of Ford married the founder's daughter, then entered the business in 1959. Joe joined his father in 1996. While Alltel is no longer a small carrier, Joe still answers customers himself to make sure their complaints are answered. "Boy, I'll tell you, it really shocks some to get a call from me," he says.

"LYNCHING." Such folksy charm is working with CenturyTel, and its defenses are formidable. By Louisiana law, the company doesn't have to hold another shareholder meeting until December, 2002, and its employees own nearly 30% of the stock. "Winning control of CenturyTel isn't going to be easy," says Craig Nedbalski, managing director of Victory Capital Management, which owns shares in both companies.

Still, Nedbalski and other investors are rooting for Alltel, given that CenturyTel has been going sideways lately. Revenues from its wireless business, responsible for 21% of its total, fell 1.3% in the second quarter. CenturyTel even approached Alltel in July, seeking to gauge its interest in buying the wireless unit. Instead, Alltel made a private offer for the whole company, which was promptly rejected. "You're looking at a lynchpin of management if they don't do something to raise the value of CenturyTel's stock," says one CenturyTel institutional investor. Such sentiments are sure to sharpen Alltel's knives.

By Charles Haddad in Atlanta

COUNTRY POWERHOUSE

Alltel's \$6.1 billion bid for CenturyTel would give the niche player new muscle

FINANCIAL POWER

A combined Alltel and CenturyTel would have 12 million customers, \$10 billion in revenue, and \$4 billion in operating cash flow

CELLULAR CLOUT

With CenturyTel, Alltel would dominate rural wireless, boasting 7.2 million customers, three times the number of its biggest rival

GEOGRAPHIC REACH

The combo would give Alltel access to 15 new states, most in the West and Midwest, in addition to its Southern strongholds

AT FIRST YOU DON'T SUCCEED...

Sam Wyly may yet get his way at CA

Sam Wyly's battle for Computer Associates rages on. That in itself is a surprise. As recently as Aug. 15, controversial Texas financier's sum-long attempt to take over the board of the software giant seemed to be peeing out. Wyly had failed to line up enough support for his plan to overthrow Computer Associates International Inc.'s chairman and founder, Charles B. Wang, and the rest of the member board. Wyly also sought to break the company into four pieces. But his push had been rejected as too radical by two influential firms that advise reholders on proxy fights, and CA officials all but declared victory.

Not so fast. Wyly quickly revised his slate, offering up instead a "short slate" of four nominees to CA's board—and this time, his name wasn't on it. The new slate has won the support of CalPERS, the influential California state pension fund. And the proxy advisers, whose recommendation can sway the votes of many institutional investors, changed their minds as well. Their take: By reining in his controversy-laden name from the slate, Wyly gave shareholders a chance to rock the boat without the risk of throwing the world's third-largest independent software company off course.

THE WIRE. With such powerful support, the proxy fight could come down to a wire. But Wyly has his work cut

out for him. He owns about 100 CA shares right, though he has 1.5 million CA stock options. And as investor Walter J. Fisher, CA's largest reholder with 21%, already pledged support Wang, despite a longstanding enmity with Wyly. In the votes of investors, and Wyly to win more than the votes of institutional investors to bail at the Aug. 29 reholders meeting.

Until, Wyly's backpedal has given him a shot at shaking up CA. If his nominees are elected, Wyly will have four friends on the board, and he has to hand them 20,000 CA stock

options apiece if they win. His goal, he says, is to try and force CA to address longstanding charges of questionable accounting, poor customer service, and lax corporate governance.

Win or lose, the Wyly agenda is sure to shake life up for Wang. Wyly has complained about how Wang treats employees and companies he's acquired. If Wyly wins, Wang will be out of a job. Even if Wyly loses, Wang will have to reach out to investors and cop to longstanding image problems. "In any part of the company...I think we can do better," he says.

Many shareholders would agree. CalPERS says CA's new way of reporting financial results is confusing, and others worry that it masks problems in generating new revenue. And CA's poor relationships with customers have caused it to miss countless opportunities to enter

new growth areas, CalPERS adds. Then there's the \$1.1 billion in stock options the board awarded to Wang, CEO Sanjay Kumar, and Executive Vice-President Russell Arzt in 1998. "It left a lot of bad taste in the mouths of investors," says the head of a large institutional shareholder.

Wyly, of course, is the least likely of governance crusaders. In 1998,

CalPERS blasted the Wyly family's chain of craft shops, Michaels Stores Inc., for "some of the most egregious corporate-governance practices and performance among [its] peers." In 1996, when Wyly



STIRRING THE POT: Win or lose, Wyly's insurgency will force CA Chairman Wang (inset) to make changes

was chairman of Sterling Software, he was chided for taking the highest pay package given to a non-CEO, \$69.6 million. It didn't help that the boards of Sterling and other Wyly-owned companies were dominated by friends and family members.

But a successful turnaround has quieted many critics. He sold Sterling to CA for \$3.9 billion in March, 2000, just as the tech bubble was bursting. And he has overhauled the Michaels board, removing himself as chairman and eschewing a poison pill. "I'm a born-again good-governance guy," Wyly boasts.

Well, that may be a stretch. But it sure helped his cause that Wyly took himself out of the running for the CA board, says Ted White, manager of corporate governance for CalPERS. "I'm willing to give Wyly the benefit of the doubt," he says. The fund, which owns 3.1 million shares of CA, or 0.5%, had planned to vote for CA's existing board but will now vote with Wyly.

This takeover artist may find that straight-and-narrow is the path to success after all.

By Andrew Park in Dallas

WYLY'S WISH LIST

If investor Sam Wyly gets to nominate four directors to the board of software giant Computer Associates, he plans to:

- Improve its relationships with customers who complain that its sales service is poor
- Revamp the company's accounting practices, which have been criticized as confusing
- Create a more responsible management by voting out the company's poison pill

SPORTS BUSINESS

THOSE SMACKDOWNS ARE TAKING THEIR TOLL

The death of the XFL is just one of the WWF's many bruises

Vince McMahon, the square-jawed chairman of World Wrestling Federation Entertainment Inc., can usually dodge the chairs thrown at him when he appears on one of his volatile TV shows. But offscreen, 2001 has been one smackdown after another for the impresario of totally tasteless television.

This summer, McMahon was slammed by a British court, which ruled that the acronym used on the World Wrestling Federation Web site belongs to the World Wildlife Fund.

Meantime, McMahon is battling the satellite broadcaster DirecTV, which has yanked the WWF's pay-per-view events in a contract dispute. Then, of course, there was the whipping the WWF took last winter when its much-hyped XFL football league—a joint venture with NBC—folded after one disastrous season. That failure alone meant a \$37 million charge in the quarter ended Apr. 30.

Little wonder, then, that the WWF, once a Wall Street darling, has fallen faster than a pudgeball dropped by The Rock. After rising as high as 21 a share in January, just ahead of the XFL's launch, the company's stock now trades at 12. And in late July, the WWF said it may have to scale back its projections for fiscal year 2002 revenues because of an "extremely soft" ad market. That prompted analysts to downgrade the stock. In an Aug. 23 report on first-quarter results, issued after *BusinessWeek* went to press, execs were expected to stick with revenue

growth projections of 8% to 10% for the year, with the caveat that a sustained ad drought could change that.

Wall Street is far less optimistic. "After the demise of the XFL, the company is faced with how to grow its business...within a market that is saturated," says Legg Mason Inc. analyst Breck

Wheeler, who lowered her buy rating in July. She sees a 6% dip in revenues this year, to \$431 million. According to earnings tracker First Call Corp., analysts are projecting a steep drop in first-quarter earnings, to \$7.29 million, vs. \$15.24 million reported for the same period last year.

The pounding hasn't done much to dim the ambitions of McMahon and his wife, Linda, the CEO. "We're still the strong entertainment brand we've been for 50 years," she says. Linda predicts that growth will come from a new franchise, "The Alliance," which will combine characters of World Championship Wrestling—acquired from AOL Time Warner earlier

this year—and from another acquisition, Extreme Championship Wrestling. The Alliance will have its own shows, pay-per-view events, and merchandising. Another strategy is to expand overseas, starting with two pay-per-view events in Britain. In addition, the company, which last year paid \$24.5 million to open a restaurant, store, and TV studio in New York's Times Square, also has branched out into music and even its own line of cookbooks and children's stories. On Aug. 25, it announced the launch of a live, two-hour, magazine-style show, *Raw Is War*, on the cable channel TNN.

FAN FATIGUE? Still, there are indications that even the WWF's maniacal fan base may have reached its over-the-top. Following years of steady growth, attendance at WWF bouts leveled off, a 2.1 million in the fiscal year ended April 30. Ratings fell by 5% for its most popular show, its Thursday night *WWF Smackdown* on UPN. "WWF executives were distracted by the XFL problems and let their story lines get a little tired," says

Peter Swan, an analyst at Pacific Growth Equities. He downgraded WWF stock from a buy to long-term buy. Indignantly, WWF executives were distracted by the XFL, but they tried to put some meat on the creative. Sales of WWF toys and videos fell as well in the past year, and the company scrapped plans to build a casino in Las Vegas.

The McMahons, who own all of the company's special voting B stock, are scrappers, though.

The WWF intends to fight the British rule, and it refuses to let the company slide under to DirecTV.

This kingdom of soap opera, and video, is not immune to the cutbacks washing over Corporate America. Bonuses for Vince and Linda in the last year were slashed by 30%, according to a recent proxy statement. Still, the \$3.3 million that the WWF chairman

and his CEO took home last year buys a lot of Band-Aids. And their take doesn't include the \$850,000 performance fees that Vince collected for dodging flying chairs.

By Ronald Grover in Los Angeles and Tom Lowry in New York



TO THE MAT: The Rock (right) on the job

THE STREET BODY-SLAMMS THE WWF

WWF's stock drops after the promise of its XFL falls short earlier this year



SEIZE
THE
MOMENT!



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A photograph of Richard Yoo, Founder & Chief Technology Officer of Rackspace Managed Hosting, standing in a server room. He is leaning against a rack of server units, looking directly at the camera. The room is filled with rows of server racks, creating a sense of depth and scale.

Richard Yoo
Founder & Chief Technology Officer
Rackspace Managed Hosting

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EDITED BY JOHN PROTOS

AOL CLICKS ON LAYOFFS

WITH A SLOWDOWN IN AD, SUBSCRIPTION, BOX-OFFICE, and music sales, investors are skeptical that AOL Time Warner can generate its promised \$40 billion in revenues and \$11 billion in cash flow. Still, the media giant is on the warpath to make its financial targets for the first year of its \$103 billion merger. On Aug. 21, the company announced a 1,700-person layoff at the AOL division and an AOL-Sun Microsystems joint venture.

Most of the reductions come from a streamlining of AOL's Web properties, such as CompuServe and AOL Instant Messenger. Five hundred of the cuts hit Netscape's e-commerce software joint venture. That may pave the way for a spin-off to partner Sun Microsystems. Meanwhile, the company has announced a new Interactive Video Div. to speed the introduction of in-

teractive TV services. But the payoff may be years away.

'GROSSLY BAD TASTE' ON WALL STREET

ON AUG. 21, A FEDERAL JUDGE dismissed six shareholder lawsuits against Morgan Stanley Dean Witter & Co. and its onetime star Internet analyst Mary Meeker, saying the complaints were in "grossly bad taste." Shareholders have been filing lawsuits against Meeker and other Wall Street research equity analysts charging them with issuing misleading stock calls. Despite the ruling, Wall Street is still not off the hook: U.S. District Judge Milton Pollack in Manhattan gave the plaintiffs 30 days to file an amended complaint against Meeker.

HEADHUNTERS' HEADS ROLL

NO ONE PROFITED MORE FROM the boom-time war for talent than executive recruiters, who often netted commissions totaling 30% of first-year salaries each time clients job-hopped. No longer. On Aug. 20, Paul C. Reilly, the new CEO of Korn/Ferry, the world's largest headhunting firm, announced a second round of layoffs, cutting an additional 20% of the firm's remaining 2,000 or so workers and mandating across-the-board executive pay cuts of 10%. Executive searches have plunged 22% since the first quarter of this year, according to the Association of Executive Search Consultants.

SCORE ONE FOR NEXTWAVE

UPSTART NEXTWAVE TELECOM took another defiant step forward on Aug. 21. UBS Warburg said it would lend the wireless carrier \$2.5 billion.

HEADLINER: GARY LYNCH

CREDIT SUISSE'S LEGAL LION

FOR FIRMS IN TROUBLE WITH the Securities & Exchange Commission, Gary Lynch is a go-to guy. So with investigations and lawsuits over its handling of initial public offerings multiplying, Credit Suisse First Boston has hired Lynch as general counsel.

Lynch's track record is impressive—on both sides of the table. As director of the SEC's Enforcement Div. from 1985 to 1989, he oversaw the agency's successful cases against merger mogul Ivan Boesky, junk-bond king Michael Milken, and Drexel Burnham Lambert. After joining the New York law firm Davis Polk &



Wardwell in 1989, Lynch steered several big Wall Street players through probes. Lynch is the second high-powered lawyer

hired by CSFB since July, when Chief Executive John Mack took over.

The legal eagles will certainly have their hands full: Angry investors have accused CSFB, and other firms of steering IPO shares to institutional traders in exchange for kickbacks in the form of unusually large trading commissions. The SEC and the National Association of Securities Dealers are investigating the charges.

Mike McNamara

CLOSING BELL

DISASTER@HOME

Months after raising \$185 million in new financing, Excite@Home is in deep trouble. In a financial statement filed on Aug. 20, its auditor, Ernst & Young, said there is "substantial doubt" that the high-speed Internet access provider will be able "to continue as a going concern." Shares closed on Aug. 22 at 56¢, 99% off its 1999 high.



The money will be used to help the Hawthorne (N.Y.) company build a communications network that supports mobile wireless devices with fast Internet connections. The deal is part of a \$5 billion fund-raising plan, further details of which are expected to be released during NextWave's bankruptcy hearing in White Plains, N.Y.

Meanwhile, NextWave is also locked in a legal battle with the Federal Communications Commission, which seized the company's wireless spectrum in 1998 when it originally sought bankruptcy protection. An appeals court said in June that the FCC overstepped its bounds. The FCC has since appealed the ruling to the Supreme Court.

ATTENTION, KMART LAWYERS

TALK ABOUT AN UGLY PRICE war. On Aug. 21, Target an-

nounced that it is taking discount rival Kmart to federal court. It accuses the retailer, based in Troy, Mich., of false advertising for its "Low to Compare" campaign, which weighs Kmart's prices against rivals'. Target claims Kmart price comparisons are false. Kmart, whose recent price cuts are part of a bigger turnaround effort, says the spat is just whining because it is falling behind in price. The spat shows just how vicious the discount retail business has become amid a slowing economy.

ET CETERA...

- Tellabs will lay off 100 workers and close a manufacturing plant in Ireland.
- The FBI arrested eight people it says stole \$13 million of McDonald's prizes.
- General Motors reaffirmed its production for the year and third-quarter profit estimates.

EDITED BY PAUL MAGNUSSON

ONE BANK DOWN. TIME TO BOLSTER THE FDIC?

Shades of the savings and loan crisis: One big bank failure, and suddenly the "FDIC Insured" sticker is front and center on the TV news—and on Capitol Hill. As Congress investigates the \$500 million meltdown of Superior Bank in Joliet, Ill., the collapse is reviving an effort to overhaul deposit insurance, the system that protects small customers when a bank or thrift goes bust. The biggest winners could be retirement savers, whose insurance protection could triple from the current \$100,000—but only if fractious bankers can agree on a host of technical issues.

There's plenty of reason for the major players to cut some deals. Superior's cost could wipe out the thrifts' insurance fund below 1.4% of deposits. That's still above the 1.25% floor mandated by law—but with banks and thrifts facing a shaky economy and inflated home values, makers fear more damage to the funds. Superior is "a timely reminder of the potential exposure," warns Senate Banking Committee Chairman Paul S. Sarbanes (D-Md.), who plans September hearings to probe bank regulators' squabbling over the thrift's woes.

BACK OUT BELOW. For banks, the issue isn't whether to reform deposit insurance, but who to pay. Under FDIC overhauls passed in 1996, well-run, well-capitalized institutions don't have to pay premiums as long as the funds are flush. If either the bank or thrift fund dips below the 1.25% floor, institutions fall off a "cliff." Annual premiums would shoot up to \$230 for every \$100,000 of insured deposits. Bad times, when they can least afford it, banks could be hit with daunting premiums," says Senator Tim Johnson (D-Me.), chairman of the Banking Subcommittee on Financial Institutions. The charges "could dry up lending in an economy that's already in trouble," warns Diane M. Casey, president of America's Community Bankers, the thrifts' trade group.

Banks, the FDIC, the Treasury Dept., and Federal Reserve

Chairman Alan Greenspan all agree that the cliff is a problem—but that's not enough to guarantee action. Last spring, the FDIC proposed that all banks pay small premiums every year, with rebates to low-risk banks. But banks are fighting across-the-board premiums because they paid huge sums to replenish the funds in the mid-'90s. "We're not going to pay for a new car just to get a tune-up," says Edward L. Yingling, chief lobbyist for the American Bankers Assn.

Reform could also founder on small banks' push to boost the \$100,000-per-depositor insurance ceiling. Independent banks—mostly rural institutions that depend heavily on deposits—argue that the ceiling, last raised in 1980, should be doubled to catch up with inflation. But many economists, including Greenspan, blame the 1980 increase for the go-go lending that led to the S&L crisis. Higher insurance limits would also require a bigger fund and more premiums—so big banks oppose the move.

A possible compromise is emerging: Boost the ceiling for individual retirement accounts and index everyone else's insurance to inflation. America's Community Bankers proposes at least \$300,000 in protection for IRAs. Given Congress' backing for IRAs in last spring's tax cut, a deal to raise the ceiling for retirement funds could give FDIC reform a push.

By late September, incoming FDIC Chairman Donald E. Powell is expected to lay out his agency's new strategy for reform. He'll face a daunting challenge. Financial legislation seldom moves without extraordinary unity among bankers—or a crisis. So far, bankers haven't agreed on enough of the details to smooth the path for FDIC reform. But Superior's failure is a warning that, even when the insurance funds are healthy, trouble lurks just around the corner. That may give Congress all the inspiration it needs to act.

By Mike McNamee



THRIFT WATCHER: Sarbanes

CAPITAL WRAPUP

ANOTHER SENATOR DOLE?

With Senator Jesse A. Helms (R-N.C.) retiring, the GOP is reaching past North Carolina's Old Guard conservatives to embrace a more moderate candidate. Look for party leaders to point Elizabeth "Liddy" Dole, a Presidential contender and two-time Cabinet member, to run in 2002. Dole's popularity has riled conservative former Senator Lauch Faircloth, who is reentering a primary battle. But in an Aug. 8 poll, Dole takes 50% of the vote, vs. 23% for Democrat Elaine F.

Marshall. In a similar matchup, it's Faircloth 36%, Marshall 32%.

CORPORATE HANDS OUT

► The incredible shrinking budget surplus is dashing hopes for corporate tax cuts. So U.S.-based multinationals are counting on an Aug. 20 ruling from the World Trade Organization to bolster their case for a big new break. A WTO appeals panel confirmed that the U.S. tax code contains an illegal \$4 billion subsidy for U.S. exporters. U.S. companies plan to argue that to compensate for its repeal, they would need a

more lucrative exemption on foreign-sourced income from affiliates abroad.

\$6.2 MILLION, 84 VOTES

► And you thought \$600 for a hammer was expensive. A \$6.2 million Pentagon pilot program to encourage Internet voting by soldiers overseas delivered only 84 votes last November. That's \$73,810 per ballot, reports the Center for Public Integrity, a watchdog group. Pentagon brass blame the cost of new technology and insist the program was designed to deliver just 250 votes anyway.

JAPAN

MEMO TO KOIZUMI

It's going to take more than a few write-offs to fix Japan's banks

COMMENTARY

Dear Mr. Prime Minister: According to the papers, you're off in the mountains recovering your strength after your July election victory. You'll need it. You now have the popular mandate you said you needed to launch your economic recovery plan, which, as you've outlined it, promises to be a sort of national root canal. And you've bravely set as your first order of business an immensely important project: fixing Japan's crippled banks.

The core of your idea is to make 10 major banks write off \$100 billion of their nonperforming loans in the next three years, something you claim is possible without a government bailout. You have promised strict monitoring of workouts to keep the process moving. Everyone knows that Junichiro Koizumi is Japan's No. 1 hard-nosed realist. Surely you know that a cleanup of that magnitude will barely make a dent in the country's bad loans. You have to do more. The economy needs a

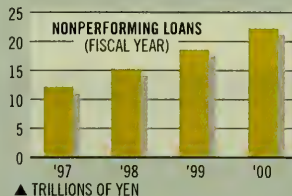
watershed event: a speedy, credible workout in which banks seize collateral and cut off deadbeats.

Time is short. The Nikkei stock index hit a 17-year low on Aug. 20, a body blow for banks, which have much of their capital in shares. New accounting rules will force them to value those shares at market prices and subtract part of the unrealized losses from their capital base when they close their half-year books on Sept. 28. Barclays Capital credit analyst Jason Rogers figures that at current market levels, Japanese lenders have \$15 billion of unrealized losses. That will hurt weak lenders such as Daiwa Bank, Chuo Mitsui Trust & Banking, and Asahi Bank. You've no doubt heard rumors of a reprise of 1998, when market panic sunk Long Term Credit Bank of Japan and Nippon Credit Bank.

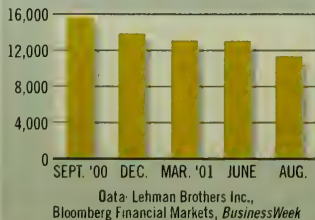
On Sept. 1, Financial Services Agency Minister Hakuo Yanagisawa will head to Washington to convince skeptics in the Bush Administration, at the International Monetary Fund, and in the financial world that everything will be fine. I agree that the banking system isn't collapsing, though smaller lenders and regional banks are in trouble. The \$50 billion the government gave the big ones in 1999 put their capital-adequacy ratios above the minimum 8% threshold. And the government replenished the deposit insurance fund and shut down or merged smaller lenders. Also, Japanese banks actually earn an aggregate



MORE BANK LOANS KEEP GOING BAD...



...AS THE COLLAPSING NIKKEI ERODES BANK CAPITAL



gate \$25 billion a year in operating income—money they make mostly from trading and fees—and have already served some \$50 billion against their known bad debts.

But the market has good reason to be skittish. The only thing that has calmed it is a more daring policy by Koizumi. Japan's banks, large and small, hold \$285 billion or so in nonperforming loans that aren't covered



Bank analysts are a pain—but they have a point when they say Japan's real dud-loan burden falls between \$600 billion and nearly \$1 trillion. You know that a vast majority of Japanese banks—most of them local or regional operations saddled with bad real estate as collateral—lack the capital and earning power to handle years of aggressive write-offs. Yanagisawa says "it is inconceivable to me to see a [government] capital injection at this time." That's a noble sentiment. Realistically, the banks will need public cash to replenish their capital after the purge and start growing again.

This is going to be a tough sell to the public. As Yanagisawa rightly points out, another

to give it the ammunition to buy bad loans in volume. The BOJ could always serve as a buyer of last resort. Next, let the RCC pay more than market value for the loans. This is key because the RCC's problem—along with its tiny budget—is that it drives such a hard bargain that the banks won't sell their loans because the write-offs are huge. If the government absorbed half the losses, the banks would probably be willing to take a haircut on the rest. The RCC would sell the collateral—generally land—or hold it until the economy recovers. That would also start the process of clearing the deadwood from the real estate market.

NATURAL FORCES. Nikko Salomon Smith Barney economist Jeffrey Young thinks it would probably take five years to clean up the banks and would cost them and the public each about \$100 billion.

MOVE FAST The country needs a watershed event: A speedy workout in which banks seize collateral and cut off deadbeats

\$50 billion injection would stink of the old syndrome of bailouts and lax oversight that created this mess in the first place. Your reformist credentials would be torn to bits. It would sweeten the pill if you pressed bank executives who haven't restructured since the bailout to resign.

But admit it. You're already giving the banks government money in an ineffective way. Having your economic team lean on the Bank of Japan to pump more liquidity into the banking system wasn't wise. The BOJ's surprise decision on Aug. 14 to buy \$5 billion more in bonds each month from the banks baffled the markets. The banks are stuffed with cash that they can't lend because few borrowers are cred-

itworthy, and those that are won't borrow in a deflationary economy.

A better use of government resources would be to turn Japan's anemic Resolution & Collection Corp. into your secret weapon. Since 1999, the RCC has spent \$8 billion buying up bad loans at an average 4% of their face value. Have Japan's Deposit Insurance Corp., which runs the RCC, issue new bonds—it could take as much as \$100 billion over time—

This \$200 billion effort would rid the banks of the lion's share of the \$285 billion of nonperforming loans floating around the system.

And what of that \$700 billion in debt that is on the verge of turning sour? With any luck, clearing the worst away would bring natural economic forces into play. Surviving companies would be more profitable without competition from weak companies on life support—especially in crowded fields such as construction and retailing. A Japanese economy growing in the 2% range by 2004 or so would keep the bulk of those loans from turning bad.

That's the theory, anyway. Look, you said that part of your grand plan was to have the RCC play a bigger role. Well, have your people chat up William Seidman, former chairman of the U.S. Resolution Trust Corp., who is coming to Tokyo next month to offer his advice. True, Japan faces a far bigger task than the savings and loan workout Seidman oversaw. But he has looked the beast in the face and defanged it.

Mr. Prime Minister, think about your options carefully. If you can get Japan out of this rut, you'll have earned a mountain holiday—on the financial equivalent of Mt. Olympus.

Sincerely,
Brian Bremner

Bremner follows finance from Tokyo.

provisions. Then there is the wild card: some \$700 billion worth of so-called classified credits—basically shaky ones. Granted, not all will sour. Yet why be optimistic? Standard & Poor's top bank analyst Takamasa Yamaoka says that \$26 billion in debt went bad over the six months ending in March. There may be more "given the fact that the domestic economy has started to deteriorate again," he frets.



EUROPE

CABLE'S NEW CONTENDER

In five years, Dick Callahan has built an empire

On a sweltering summer day, contractors working for ONO, a Spanish cable startup, are using a huge circular saw to carve a gash along a public square in the eastern town of Alaquas. The workers are putting in long hours to bring to life the vision of an American telecom pioneer, Richard J. Callahan. He and his partners are spending \$2.5 billion to wire a huge region of Spain around Valencia, the third-largest city, not only for TV but also telephone service and high-speed Internet access.

ONO is but one piece of Callahan's fast-growing cable business. Since setting up his own company, Callahan Associates International, in 1996, this prolific dealmaker has strung together a web of European cable properties spanning three countries and 8.5 million subscribers. That is comparable to the third-largest U.S. cable company, Philadelphia-based Comcast Corp. More impressive still, Callahan, 59, has built his empire with a tiny organization and little of his own capital.

At a time when investors are dump-

ing shares in some of Europe's biggest cable operators, Callahan boasts an enviable roster of backers. The list includes New York-based Blackstone Group, Bank of America, and Spain's Banco Santander Central Hispano. Callahan, who has a 30-year track record in the telecom and cable industries, is racing to satisfy the demand for huge volumes of data and entertainment that he is betting will soon emerge. "I am a broadband man," he says. "I don't care if it is by land, or sea, or air."

HUGE DEBT. Still, Callahan concedes that "this is an awkward time to be in this business." Some of Europe's onetime cable darlings have seen their share prices plunge on worries that they won't be able to service their huge debt. Callahan's ventures, too, are expected to have negative cash flow for several years. But he doesn't have to worry about stock prices. His outfit, which has offices in Denver and London, is a private equity player, one of

ON MARGIN
Callahan has spent billions buying systems, using little of his own money

Europe's biggest. So far, his various businesses have raised \$4.7 billion in equity and \$8.4 billion in debt—of which about \$4 billion remains in reserve. Last summer, he

tapped Andrew Sukawaty, former CEO of Sprint PCS, for the post of president at Callahan Associates. "He has a nose for finding deals, and they are good operators," says William Strittmatter, managing director of Capital Telecom, which invested \$13 million in ONO.

Callahan is no stranger to Europe. He spent the early 1990s as the London-based chief of international operations for U S West, a Baby Bell now owned by Qwest. He also helped start TeleWest Communications, now Britain's second-largest cable company, and One2One, a mobile-phone operator now owned by Germany's Deutsche Telekom. His biggest deal to date is the roughly \$2.5 billion he agreed to pay last year for a 55% stake in the German cable system he rechristened Callahan Nordrhein-Westfalen (CNRW). Now he is on the verge of adding another \$1 billion system to his German network. But Callahan is not the only U.S. cable mogul shopping in Germany. John Malone's Liberty Media Corp. is acquiring a 10-million-subscriber system from DT for about \$4 billion.

Callahan is running into some turbulence. His companies may not have listed shares, but their \$2 billion in high-yield bonds have taken a hit. CNRW are now at 64¢ on the dollar, reflecting worries about high debt. But Callahan content to bide his time, hoping that today's nasty climate will send some choice morsels his way. "If you run a good show, you are going to get more opportunities," Callahan says. Stay tuned for the next act.

By Stanley Reed in Valencia, Spain, with Jack Ewing in Frankfurt

Europe's Cable Guy

SPAIN	GERMANY	BELGIUM
Building ONO cable network from scratch at a cost of \$2.5 billion Subscribers: 250,000 Backers: GE Capital, BSCH, Eugenio Galdón, CDP Capital Communications	Is plowing upwards of \$3 billion into two cable systems Subscribers: 6.3 million Backers: Blackstone, CDP Capital Communications, BSCH, Bank of America	Took 54.2% stake in Telenet in April, 2001, for \$918 million Subscribers: 2.2 million Backers: Evercore Capital Partners, CDP, Merrill Lynch

Data: Callahan, BusinessWeek

ARGENTINA

BEYOND THE
DEFAULT DRAMA

Argentina's private sector is in a tailspin as well



iving hand to mouth is nothing new for Francisco dos Reis. At age nine, he dropped out of school to peddle candy on the streets of Buenos Aires and help his parents put food on the table. After scraping together enough capital to start his own company 40 years ago, dos Reis thought his days of poverty were behind him.

Now, with Argentina's economy mired in a three-year recession, he is struggling to stay afloat. These days, instead of turning out rubber rollers for printing presses, the seven workers at his tiny factory on the outskirts of the capital keep busy by performing mundane tasks like repainting the shop-floor bathroom. Earlier this year, when he didn't have enough cash to cover the payroll, dos Reis, 60, pledged his home as collateral for a \$45,000 loan. "At any moment I could lose everything," he says.

DRACONIAN. As investors the world over speculate whether Argentina will default on its \$130 billion debt or devalue its dollar-pegged peso, the economy is caught in a tailspin. Interest rates are soaring, capital flight is intensifying, and consumer spending has plunged to new lows. The slow-motion collapse of the private sector has been overshadowed by the government's scramble to shore

up the public finances. Economy Minister Domingo Cavallo has imposed draconian spending cuts in a last-ditch effort to erase a pernicious fiscal deficit. And he recently persuaded the International Monetary Fund to give Argentina \$8 billion in new money, on top of the \$40 billion aid package delivered in December.

The burning question, though, is whether any of this will revive an economy that seemingly has already given up the ghost. Publicly, big Argentine companies endorse Cavallo's moves. Privately, they confess they're switching from pesos to dollars. Demand for currency futures has surged as businesses hedge their peso positions in preparation for the worst. Meanwhile, Argentines are emptying out their bank accounts. Close to \$9.5 billion, or roughly 10% of

IN JEOPARDY
As business dries up, toolmaker dos Reis could lose his home

all deposits, has fled the banking system since July 1. "We are confident the money will return once things calm down," says Manuel Sacerdote, president of BankBoston Argentina.

Business execs might breathe easier if they could detect a pickup in domestic demand, the main driver of the economy. No chance: Consumer confidence has been battered by rising unemployment

and higher taxes. Alto Palermo, which manages some of the country's leading shopping malls, saw sales fall 17% in July—a stunning decline considering this is the month in which all Argentine workers collect their midyear bonuses. "For too long, Argentina has been living beyond its means," says Mariano Rodriguez Giesso, president of Giesso, a century-old men's clothier that has suffered a 20% drop in sales in recent months.

SALARY CUTS. Companies across a variety of industries are cutting salaries, with little resistance from Argentina's normally feisty unions. Workers at Ford, Volkswagen, and Fiat have had to swallow 35% reductions in wages during periods when assembly lines are idle. Overall unemployment rose to a six-year record of 16.4% in May.

Some businesses are downsizing themselves right out of existence. A total of 726 companies filed for bankruptcy in the first half of 2001, a 16% increase from the same period last year. Sky-high interest rates are partly

to blame: The prime rate is now hovering at near 40%. "Credit today simply does not exist," says former Economy Minister Roberto Alemann. On Aug. 8, Compañía de Alimentos Fargo, a top breadmaker, missed a \$1.5 million payment on its debt, signaling what could be the start of a worrying trend.

Wage cuts, layoffs, bankruptcies—all of these are aggravating tensions in a country that has long prided itself as one of the most socially equitable in Latin America. Mobs of angry out-of-work citizens have intensified a campaign to block major highways in a bid to draw attention to their plight. The roadblocks are contributing to the generalized fear that things could unravel at any moment. "Nobody wants a default, but I'm afraid it's already too late," says toolmaker dos Reis. It may also be late for many of Argentina's companies.

By Joshua Goodman
in Buenos Aires

NO RECOVERY IN SIGHT



today's
business
thought:

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IP network
and other
companies'?

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ROSE BRADY

NEW SANCTIONS AGAINST IRAQ? NOT WITHOUT A CARROT FOR RUSSIA

Can the U.S. and Britain overhaul the U.N. sanctions regime against Iraq? That's a key item on the diplomatic agenda for this fall. The aim is to allow more consumer products to flow into the country while stepping up pressure on Saddam Hussein by tightening controls on goods that can be put to military use. Another goal is to block smuggling and surcharges that bring Iraq illicit dollars. The push for "smart sanctions" comes partly because the U.S. and Britain have found themselves increasingly isolated

Iraq policy. Much of the rest of the world—from Iraq's neighbors to countries like France and China—believes a decade of U.S. and British-led sanctions has punished the Iraqis enough. Smart sanctions are an effort to ease the pain on civilians while preventing Saddam from producing nuclear, biological, or chemical weapons.

SADDAM'S FRIEND. But smart sanctions may be a nonstarter. The reason: Saddam has a close friend in Russia. In June, Moscow sank an earlier U.S.-British proposal by threatening to veto it in the U.N. Security Council, even though France and China were persuaded to go along. Iraq owes Russia \$8 billion, and Saddam won't repay the debt if Russia backs smart sanctions. Also, Russian companies have been supplying Iraq with close to \$700 million in goods annually through the existing oil-for-food program, which allows Saddam to sell oil and buy food and other goods. And Russian officials say oil-equipment suppliers and other companies are on the verge of signing \$2.5 billion in contracts with Iraq. Saddam switched business from France to Russia after the June decision. "Russia is unlikely to fall in line with U.S. demands on smart sanctions," predicts Andrei Gerasimov, director of the Council on Foreign & Defense Policy in Moscow.

It would take a mighty quid pro quo to get the Russians to

cave in. But the U.S. has little to offer. One proposal, to channel money from a U.N. escrow account to pay off Iraq's debt to Russia, has already been rejected. Bush is unlikely to trade on key initiatives like his missile defense system, which Moscow opposes unless the U.S. negotiates a treaty to replace the 1972 Antiballistic Missile Treaty. "We want to change the Russians' behavior, but we haven't offered the carrots to [do it]," says Michael A. McFaul, a Russia expert at the Carnegie Endowment for International Peace.

The U.S. and Britain face a Nov. 30 deadline for resolving the issue. That's when the U.N. must decide whether to renew the oil-for-food program. Secretary of State Colin L. Powell and Russian Foreign Minister Igor Ivanov are expected to discuss sanctions when they meet at the U.N. General Assembly session that starts on Sept. 24. Bush will also have a chance to cajole Russian President Vladimir V. Putin at an Asia-Pacific Economic Cooperation meeting in Shanghai in October and at a summit scheduled for Bush's Texas ranch in November.

If Putin can't be swayed, pressure will grow within the Administration to take a tougher line on Iraq. Pentagon hard-liners are pushing for more bombings—a policy likely to spur protests from Arab countries and even Europe.

Saddam, meanwhile, is benefiting handsomely from the status quo. Analysts say he could be

raking in \$300 million a year or more by slapping illegal surcharges on Iraqi oil and sneaking oil out through neighbors such as Syria. That's money he can use to buy weapons. As Saddam lures his neighbors and Russia to further boost business ties with Iraq, the U.S. and Britain may once again have to rethink sanctions policy—or face fighting the Iraqi strongman mainly on their own.

With Catherine Belton in Moscow and Stan Crock in Washington



FOOD AID: Paid for by oil

GLOBAL WRAPUP

SINN FEIN'S LATEST DEBACLE

► The arrest of three suspected Irish Republican Army members in Colombia on charges of training a local Marxist guerrilla group is a potentially huge embarrassment for Sinn Fein leader Gerry Adams. Sinn Fein, the political wing of the IRA, is under pressure from London and Dublin to persuade the paramilitaries to give up their weapons so the stalled Northern Ireland peace process can restart. The Bush Administration is already skeptical of Adams, who was buddies with

former President Clinton. Things could get frostier if the charges, lodged on Aug. 21, are proven or if the IRA is later linked to Latin American drug trafficking. The IRA men are being held in a Colombian prison while investigations continue.

A BATTLE IN THE ALPS

► A fight has broken out in the French government over whether to reopen the Mont Blanc tunnel in the Alps linking France and Italy. The tunnel has been closed since a 1999 fire that began on a freight truck

killed 39 people. Transport Minister Jean-Claude Gayssot is preparing to open the tunnel in November, but Environment Minister Yves Cochet wants to ban heavy trucks from using it. Some 4,000 trucks used the tunnel daily before it was closed.

Residents in the Chamonix Valley on Aug. 19 voted overwhelmingly against reopening the tunnel to freight traffic. Apart from safety issues, local businesses say the noise and pollution hurt their lucrative tourist industry. Gayssot has called a meeting for Oct. 1 to hear local complaints.

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A REPORT ON ELECTRONIC BUSINESS

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How a Bond
Dealer Scored a
Success Online

TECH INVESTING
Why Bear David
Tice Is Prospering

Life In Microsoft's Crosshairs

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update could make
Rob Glaser's
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RealNetworks be
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In the short history of the Net, Rob Glaser is a true visionary—the father of RealNetworks, the pioneer of streaming audio and video. But as the economy has slowed, RealNetworks' profits have evaporated. And now, with Microsoft's Windows XP threatening his business, Glaser is in for the fight of his life. A portrait of a mercurial leader in a tight spot

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home page



Your Cheatin' Phone

Back-to-school tip: If a gadget delivers information, sooner or later someone will try using it to cheat on a test. Take some naughty economics students at Holland's University of Maastricht. During exam bathroom breaks, they would hide in stalls and use their mobile phones to smuggle answers to classmates via on-screen text messages.

Searching students and jamming signals are illegal. So the school bought a Mobifinder, a device that beeps when phones are in use nearby. Officials bet that just telling potential miscreants about the gadget would do the trick. "It's good to have them think it's possible to be caught," says spokesman Marcel Schrijnemaekers.

This fall, the school is hoping for a repeat of the success it saw last semester. The Mobifinder didn't expose any cheaters, so officials think the problem is history. Still, Schrijnemaekers says with a sigh, "students are very inventive."

—Andy Reinhardt

Death Valley Days

In good times, a favorite affectation in Silicon Valley is the license plate boasting of tech riches. Eric Wold knows: He had one, THXNTCS, a thank-you to NetCurrents, a small software company that in 1999 bought Infolocity, an even smaller outfit Wold helped found.

Now he's repenting—in a way. The San Francisco stock analyst-turned-software executive reregistered his BMW this spring with a mournful twist. The car's new plate: DLISTED. "I get a lot of positive comments," says Wold, 29, a finance exec at NightFire Software in Oakland. "Ninety-nine percent of the population has been laid off from a dot-com, and they've learned to laugh at it."

Maybe 99% is a tad high, but Wold's onto something: Other Californians have registered DOTGONE, DOT-BOMB, and CHPTR11. So, how many of the companies Wold covered for Wells Fargo Van Kasper have been delisted? "Just one," Aspeon Software, a maker of point-of-sale systems, he says. Others, he notes with a gallows laugh, "are pretty close." —Timothy J. Mullaney



Fool Me Once...

Wasn't Webvan stock worthless enough the first time? Shareholders got wiped out like yesterday's paper towels when the online grocer filed for bankruptcy in July. And were it not for a sharp-eyed seller, wannabe collectors of Webvan stock certificates would have gotten soaked for even more than Webvan's top price of \$34 a share. Net auctioneer eBay had to shut down at least two bidding wars for the collectible shares—because the certificates advertised didn't exist.

There was at least one bona fide auction of a Webvan share. Gregg Freishtat, co-founder of software outfit VerticalOne, paid \$500 to Oregon collector Jeffrey Smith. Freishtat says he'll hang it over his desk as a reminder not to take his investments for granted. Afterward, bids climbed to \$305 apiece in two copycat auctions. But Smith sensed a problem: The picture of each certificate online had been copied from his electronic ad. The clue? "It had my name on it," Smith says.

eBay has taken no action against the would-be scammers other than cancelling their memberships. No word yet on whether the errant shares were recommended by any Wall Street analysts. —Faith Keenan

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BY ELLEN NEUBORNE

ellen_neuborne@ebiz.businessweek.com

Irksome—and Effective

Desktop 'pop-unders' allow for more complex ads, and healthy response rates

Raise your hand if you like junk mail. What, nobody? O.K., who enjoys telemarketing calls? Still no takers? Fortunately for advertisers, it doesn't much matter. Advertising isn't a popularity contest, and consumers often dislike ad tactics that work. Direct mail. Inane TV jingles. Perfume-infused magazines. Annoying, yes, but they get the job done. That's important to keep in mind when

evaluating the Web's latest ad phenomenon, the pop-under.

If you don't know already, a pop-under is a screen that launches beneath your browser window while you visit a site such as MSN, Weather.com, or Yahoo! Most surfers don't notice them until they close their browser and find the pop-under ads lurking on their desktops, hawking a company or a product.

That's not to everybody's liking. Christine Mohan, a manager at New York Times Digital, says reaction to the site's pop-under ads has been mixed. "In the beginning, people were taken aback—they didn't know where it was coming from," she says. That's an understatement. Everyone I've talked to about pop-unders, which began cluttering desktops last year, had much stronger words. "They're horrible," says my neighbor Joy. "Please tell me you're writing about how they're going away soon."

Sorry, Joy. The Times and others will continue to offer pop-unders—and that's smart. Assuming ads must be lovable is a myth the Internet community has to get over, and soon. Dot-coms produced years of creative, cute—and ultimately useless—television advertising.

Pop-unders, on the other hand, are a powerful marketing vehicle. Take X10, easily the best-known user of the format. Since launching a pop-under campaign this spring, the wireless camera maker has risen from obscurity to become the fourth most visited site on the Web, outstripping even the likes of e-tailer Amazon.com and auction site eBay. X10 won't talk about results, but it's hard to ignore the brand-building boost it has gotten from pop-unders. Consumers may complain about those ads, but they've seen them.

Other businesses are testing the pop-under waters. They cost more than banner ads—about \$5 per 1,000 impressions, vs. \$1 for

banners. Early adopters say they're worth it. Discount e-tailer Half.com Inc. says traffic is up 66% since it began using pop-under ads on MyPoints.com and *The New York Times's* site. Diet company Nutri/System Inc. has an even better claim: Not only are pop-unders driving site traffic, the visitors are buying. "We are definitely seeing sales," says Chris Dominello, vice-president of marketing. "It's a format that works."

And it's on a lot of desktops. Online ad network Fastclick.com

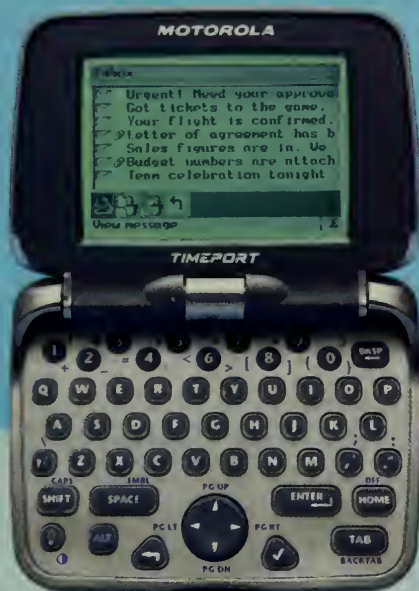
Inc. has seen sales of pop-unders nearly double every month since November, says CEO David Gross. In that time, the company has served more than 2 billion pop-unders for 20 advertisers on 4,000 sites. Why the surge? Pop-unders are larger than either pop-up or banner ads, and can present more complex graphics. They contain anything from discounts to mysterious teasers. "It's a richer ad with more story to tell," Gross says.

Despite such enthusiasm, there are doubters. Analyst Marissa Gluck of Jupiter Media Metrix says pop-unders are a mirage. The impressive 10% click-through rate some have shown isn't as good as it seems: Most visitors leave within seconds. Only about 4% of them really look at the site, she found in a study.

Still, 4% is better than the sub-1% most banner ads turn in today. More importantly, 4% is better than less-than-popular—but ultimately effective—ad strategies already in use. Only 1.2% of Sunday newspaper coupons get redeemed. In direct mail, a 2% response is typical. Telemarketers know most folks will just hang up. These tactics elicit consumer groans—yet respectable response rates. That's why they're still around. If the early returns are any guide, pop-under ads will be with us for a long while, no matter how much we hate them. ●



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BY ROGER O. CROCKETT

roger_crockett@ebiz.businessweek.com

Let the Buyer Compare

If customers can check rivals' prices at your site, they're less likely to walk out

A new digital camera on Amazon.com beckoned Eric Mueller like a siren song. It was cutting-edge and "cute," the 29-year-old Web designer thought. So he slipped the \$400 gadget into his virtual shopping cart. He continued to browse, tossing in a book and a CD. Then, as Mueller got to checkout, reality hit. "This is silly," he recalls thinking. "Let's see if I can beat Amazon's price." He bailed, and still

hasn't bought the camera—or the book or the CD. But when he does, he's likely to skip Amazon and buy from one of the cut-rate shops he found through a comparison-shopping site.

This deal-seeking instinct should frighten e-tailers. Nearly two-thirds of online shoppers make it all the way to checkout and, like Mueller, leave in search of a better deal, according to Forrester Research Inc. Of these, more than 40% split to compare shipping costs, and 35% say they're looking for a lower price on the product itself. And of those who go hunting, 70% don't return. Nearly a quarter find a lower price elsewhere, and most others get turned off by the search and don't buy at all. My brief career in sales taught me this: Allowing a prospective buyer to walk out is a no-no. "You can't let [customers] get away," says Forrester analyst Christopher M. Kelley.

There's a way to keep deal-seekers like Mueller from escaping: Let them make comparisons right on your site. For years, sites such as MySimon.com and PriceGrabber.com have helped consumers find bargains by ferreting out the lowest prices for anything from camcorders to jigsaws. But once customers bolt to a competitor, they could be gone forever.

Booksamillion.com, a low-cost online bookseller, hangs on to prospective sales by serving up prices from its top rivals. Punch a title into the site's comparison engine, and up pop prices from Amazon.com, Barnesandnoble.com, and others. In more than a dozen searches for various books, Booksamillion beat its competitors handily. Even if that's not always the case—something Booksamillion President Terry G. Finley admits is possible—the compari-

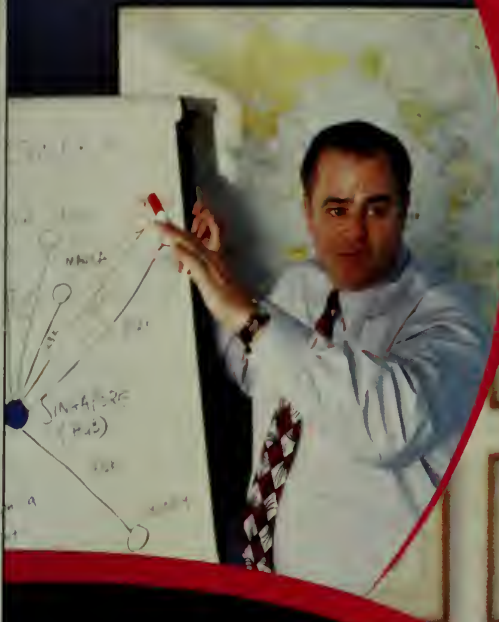
son engine helps differentiate the site from its rivals. It's popular: At least 40% of new visitors use the pricing tool, Finley says. And it has helped boost sales, although Finley wouldn't provide specifics. "We think it has become core to the experience," he says.

Sure, many merchants cringe at the thought of posting details of another company's products on their home turf. But by comparing features that set you apart from rivals, you can win a lot of customers. UAL.com, the site of United Airlines Inc., shows how its operations stack up against competing carriers on points including: on-time departures, the number of stops, and the availability of seats. These might sway a buying decision as much as price, which the engine also compares. United can't say what effect this service has had on sales, but spokeswoman Chris M. Nardella says it improves the airline's image among consumers by

making it seem more open. "We want to keep our site as user-friendly as possible," she says.

The lesson? Letting consumers compare is a good way to keep them from abandoning you at checkout. Of course your price must be competitive, but many shoppers will pay a few extra bucks for more reliable delivery or better service. "Regardless of what you're selling, there are levers you can pull to entice consumers away from your competitors," says Forrester's Kelley. If done right, you might even get customers like Mueller snapping pictures with your camera, rather than surfing for a deal. •





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BY TIMOTHY J. MULLANEY

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Online Pics: A Sure Shot

The only question is, which of these four sites is best suited to your needs?

Start with a roll of shots of my 3-month-old son, Sam. Add the melee that results when you offer 150 journalists a freebie—I'd pay to develop their pictures in exchange for help in evaluating online picture services. You may call the result chaos. Me, I call it a column.

Online photography is a bona fide trend, because working with photos digitally is more fun than prints alone. Through sites such as Snapfish, AOL You've Got Pictures, Shutterfly, and Ofoto, people get film developed and their pictures posted in private areas online. Then they share their shots with friends through private e-mailed links. It's huge for new parents: My six siblings get instant, illustrated Sammy-Grams. God knows when I'd have mailed pictures to everyone. I know, too. Never.

All the services provide simple online software to crop or touch up digital images. Then you can order prints, or put pictures in a frame, on a coffee mug, or on a compact disk. They also let you directly zap pictures taken with a digital camera to their sites.

What separates top photo sites from the rest is how they price paper prints. Some, like Snapfish.com and AOL You've Got Pictures, offer both prints and online pictures for a relatively low price. Others, like Shutterfly.com and Ofoto, push you toward only posting pictures online. Their base price includes processing and online posting—but not prints. Yet every one of my colleagues wanted prints. At Ofoto and Shutterfly, they start at 49¢ each—or \$13.23 for the 27-shot disposable camera I bought the Mother's Day morning Sam came along—on top of the base price.

The verdict? Snapfish has the best combination of price (including prints) and online features. The rundown: **AOL You've Got Pictures.** This service left even an America Online fan ice cold. You take film to a local AOL partner such as a supermarket or drugstore, just as we've always dropped off film. Sam's shots went to a CVS pharmacy.

The good news: It's fast. The shots came online in a day, and

prints hit CVS a day or two later. They also have the most tchotchkes, like frames and mugs.

The bad news: At \$8.99 a roll, its basic price is the highest of the four sites. Also, cropping and editing photos using AOL is harder than it should be. Worst of all, AOL's price varies depending on which partner develops your film. CVS hit me for \$15.98. I won't go back.

Ofoto. Ofoto charges \$2.95 a roll, but for online posting only. Ofoto receives film by mail.

The good news: Its attractive interface is easy to use.

The bad news: It's slow for Easterners because your film goes to Berkeley, Calif.

Shutterfly. Shutterfly is a more refined Ofoto. You mail film in and the pictures are posted online for \$4.79 a roll, also not including prints.

The good news: Editing instructions are even better than Ofoto's.

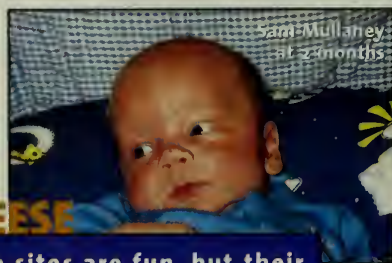
The bad news: Every roll of film must arrive in a separate envelope.

Snapfish. This site delivers prints and online posting for less than AOL. Its interface is better, too.

The good news: At \$1.99 a roll, plus \$1.99 for shipping, it's cheap. A West Virginia lab means fast online posting for Easterners. Sorry Westies.

The bad news: It has cards and CDs, but no mugs or other goodies.

With Microsoft Corp.'s Windows XP adding photo-sharing capabilities, the online photo business should reach more people and get more innovative. So, before long, Internet photography will really be a snap. •



SAY CHEESE

Photo Web sites are fun, but their quality can be uneven. Here's how four leaders stack up:

AOL You've Got Pictures

Relatively expensive, at \$8.99 a roll for developing film and making prints. Clunky, annoying interface for photo editing.



Ofoto

Cheaper, at \$2.95 a roll, and easy to use. But basic fee covers only online posting of photos. Prints are expensive (49¢ and up).



Shutterfly

Basic price of \$4.79 a roll covers online posting. Prints are extra. Real people want real prints. But editing tools are first-rate.



Snapfish

Prints are cheap, at \$3.98 a roll, and online posting is thrown in. An online photo service for the masses.





"Not working?"

"No."

"What if we changed the tail angle?"

"Like this?"

"Yeah."

"Okay, Orville. Let's give it a shot."

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Program monitors:
"We come to in,"
says Glaser

by

JAY GREENE

As a boy growing up in the middle-class New York suburb of Yonkers, Robert Glaser was a rabid New York Mets fan. His home was just five miles from Yankee Stadium, but Glaser chose to take a one-hour subway ride to

Shea Stadium to watch the ragtag Miracle Mets, who shocked the sporting world by winning the 1969 World Series. A numbers whiz who memorized large sections of the 3,000-page *Baseball Encyclopedia*, the young Glaser could instantly recite the number of bases Bud Harrelson stole or the number of home runs Tommy Agee crushed. When anyone asked what he wanted to be when he grew up, Glaser would say he planned to replace Mets announcer Lindsey Nelson. "Robert always liked the underdog," says his mother, Barbara.

These days, Glaser is the underdog. The 39-year-old software entrepreneur pioneered streaming media—technology that zips audio and video files over the Web and allows people to view and hear them on their PCs. The Internet became a multimedia affair. And Glaser's RealNetworks Inc. turned into a dot-com darling, rewarding him with a personal fortune of \$5 billion when the stock was at its peak in February, 2000. Real turned a modest profit of \$6 million in 1999 and nearly doubled its sales during the first half of 2000, but slackening demand for the multimedia software that Real sells to corporate customers and a falloff in advertising on its Web sites have since taken their toll. Revenues slid 24%, to \$47.9 million, in the quarter ended June 30, and, since mid-2000, the company has lost \$150 million and has seen \$14 million in market capitalization evaporate. On July 26, Real laid off 15% of its workforce. Today, Glaser's stock is worth just \$380 million.

In streaming media, his RealNetworks is battling hard to beat Microsoft

It could get worse. On Oct. 25, Real's chief rival, Microsoft Corp., plans to release its new operating system, Windows XP. This is the soft-

BRIAN SHALE

Rob Glaser Is Racing Upstream

ware powerhouse's most aggressive move ever to supplant RealPlayer—the Real software that can be loaded into PCs—as the leading source for audio and video on the Internet. Click on a Web music file from the Start menu, load a CD, or tune into an online radio station, and Windows Media Player launches to handle the task. Real has cut deals with five of the seven top PC makers to have its playback software included on their computers, but, even when Real is an alternative, Microsoft's media player is easier to find on Windows XP screens and menus.

To Microsoft's critics, this could be an instant replay of the way the software giant vanquished Web-browser pioneer Netscape Communications Corp. Threatened by Netscape, Microsoft bundled its browser with Windows at no cost, gradually taking over the market lead—until Netscape gave up and sold itself to America Online Inc. Microsoft's bundling led federal and state trustbusters to file their landmark antitrust case, and government lawyers are now eyeing how it's handling media player technology. "We're looking very closely, with

concerns that Microsoft may be violating the law as it did previously," says Iowa Attorney General Tom Miller, one of the parties to the case. Microsoft's enemies warn that unless the government acts now, the company will have yet another monopoly. "They would have control over the way music is digitized, the way digital music is played, and control over the royalties," says AOL Time Warner Inc. Executive Vice-President Kenneth B. Lerer. "We don't think one player should own the market."

Microsoft scoffs at such an idea. The software giant says it intends to become the No. 1 streaming-media company. But it plans to get there on the back of its technology, not by leveraging its operating system monopoly. "We out-innovated Netscape, and we're out-innovating Real," says Will Poole, vice-president of Microsoft's Windows digital media division. Microsoft's allies expect it to overtake Real eventually. Microsoft has "come in on the back of what Glaser has done. It has made his lead subject to question," says Edgar M. Bronfman Jr., vice-chairman of media giant Vivendi Universal.

For former Microsoft exec Glaser, beating onetime mentor William H. Gates III is a personal quest, not just a professional vocation. He vows that Real won't become the next Netscape. He has faced down the giant before, and he doesn't view the threat from Windows XP as being dramatically different from previous bids by Microsoft to dislodge Real. Add to that the recent appeals court decision—which found Microsoft violated antitrust laws by preventing computer makers from adding its competitors' software to Windows—and Glaser thinks he has more than a fighting chance. "Once the appeals court came down and said you can't create that sort of hammerlock, it changed the dynamics," Glaser says.

His is one of only a handful of companies that have taken Microsoft head-on, and it is still winning. In July, more than twice as many home-PC users—29.8 million—used Real's software to watch audio and video over the Web as used Microsoft's rival product, according to Nielsen/NetRatings. Worldwide, 215 million people have registered to use Real-

Real Headaches

RealNetworks is the leading provider of software for audio and video delivery via the Net, with 215 million consumers signed on and more than 400,000 streaming-media computers within companies.



THE CHALLENGE: SLACKENING DEMAND

His dot-com customers are failing, and old-line media companies are cutting back. Real's first-half software sales slid 15%.

GLASER'S STRATEGY

He hopes to ride out the slowdown with \$341 million in cash. When demand returns, he aims to be top dog.

THE PROSPECTS



Solid. Glaser is making a long-term bet. With his deep pockets and market-leading technology, Real is positioned well.



THE CHALLENGE: MICROSOFT

The software giant includes its own media software with each copy of Windows. And it's catching up, technology-wise.

GLASER'S STRATEGY

Real has deals with five of the top seven computer makers to include its software on their machines. Plus, AOL uses the technology.

THE PROSPECTS



Holding on. Real's player is ubiquitous. But as long as Microsoft's monopoly is unchecked, Real will strain to stay ahead.

Player (most of them using basic, free versions of the software), making RealPlayer ubiquitous among Web surfers. More than half of the audio and video files on the Web are in Real's format, making it costly for Web sites to switch to Microsoft's technology. "We've got good content. We've got the most consumers," he says. "Once you've got that kind of network effect, it's deep and fundamental and

Last fall, he introduced GoldPass, a subscription service that gives users a souped-up media player as well as access to a wide selection of music, round-the-clock videos from CBS's *Big Brother* reality show, and live baseball broadcasts. Already, more than 300,000 customers pay \$9.95 a month for the service.

This fall, he'll launch MusicNet, an online music subscription service that will

ever they want it. While the slow adoption of broadband connections to the home has delayed the fulfillment of his vision, Glaser plans to have Real's technology providing the foundation when such connections are as common as cable TV is today. "I have the chance to help create something that could become one of the most important phenomena of the next generation," he says. As a bonus, he could be remembered as one of the few who took on Microsoft and won.

For Glaser, anything short of total victory would be a failure. "We come to win. That's a core value in the culture," he says. Mark Cuban, co-founder of Web media pioneer Broadcast.com Inc. and owner of the Dallas Mavericks, says: "It's a zero-sum game for Rob. He either wins or he loses everything." That attitude helps explain Glaser's edgy relationship with Microsoft Chairman Gates. During his 10 years at Microsoft, Glaser prospered under Gates's tutelage. Now, even though some friends say Glaser still seeks Gates's approval, he's determined to show the Microsoft chief who's boss in the streaming media realm. And he's not afraid to criticize Gates. "I don't think I'd take an antitrust class from him," Glaser quips.

Yet Glaser's toughest adversary may be

Glaser the critic: "I don't think I'd take an antitrust class from [Gates]"

durable." Most analysts agree. "Real is the dominant force in streaming media," says Jupiter Media Metrix analyst Seamus McAteer. "Don't expect it to roll over."

Still, Glaser knows Microsoft can eventually outdo him if he has to fight it out on the PC desktop. So he's coming up with new offerings that take Real out of the direct line of fire. "The way you beat Bobby Fisher is you don't play chess," Glaser says. A new RealPlayer due out this fall blends Real's media-playback technology with its RealJukebox, a program that stores and finds favorite music and video files. At the same time, Glaser is trying to turn Real into a media delivery company.

use Real's technology to provide access to the music catalogs of its three partners, AOL Time Warner, EMI Group, and Bertelsmann. It's a huge opportunity. Jupiter Media Metrix Inc. expects subscription music sales to climb from \$29 million this year to \$789 million in 2004. But analysts don't expect Real to pocket a big payoff anytime soon. "This is a grand experiment," says CIBC World Markets analyst John Corcoran. "We're cautious about it."

Undeterred, Glaser envisions a time when consumers will be able to surf a sea of channels on the Web, picking through television programs, movies, and music to enjoy whatever they want, when-



THE CHALLENGE: SHRINKING AD DOLLARS

The Web ad business is bleak. Like that of most other Web powers, Real's ad revenue has tanked, falling more than 60% last quarter.

GLASER'S STRATEGY

He's relying less on banner ads. Instead, he's creating new formats, gussied up with audio and video, hoping advertisers will pay more.

THE PROSPECTS

Dicey. No matter what kind of ads he crafts, budgets for online ad buying are weak, and that won't change soon.



THE CHALLENGE: NEW BUSINESSES

With revenues tanking and facing pressure from Microsoft, Glaser must find new businesses and sources of revenue to keep growing.

GLASER'S STRATEGY

He's launching subscription services such as GoldPass, which lets people tune into baseball games, and MusicNet, an online music service.

THE PROSPECTS

Good Start. GoldPass is starting well, with 300,000 subscribers, but nobody knows if consumers will pay for music.



Nice facade. Bad infrastructure.

INFRASTRUCTURE: SOONER OR LATER, IT MATTERS.

INFRASTRUCTURE. The physical foundation of any thriving enterprise. In the world of technology, infrastructure means integrating the servers, software and storage systems of an e-business into one finely tuned and solidly reinforced machine.

To put it simply: as goes infrastructure, so goes the enterprise. All the ingenious products, brilliant marketing and champion deal closers won't amount to much if your supply chain is buggy, the network crashes or the databases fail (and all you have to say is, "Sorry, but the computers are down; can you call us back tomorrow?").

Infrastructure is about hard questions: What platforms should I use? How do I plan for the unexpected? Will it grow when we grow? Will it work with new technology in the future? Will it build upon my current systems? Can I link it to my customers' and suppliers' systems? I've heard all about open

standards, but what exactly can they do for my business? What about outsourcing? And how am I going to finance all of this?

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The sooner, of course, the better.



himself. He is a demanding taskmaster, and when he's not pleased with results, frustration sometimes boils over into angry outbursts. "Rob's an absolute genius," says one senior executive who left because of Glaser's behavior. "But he's an incredibly difficult person to work with." Not infrequently, Glaser belittles workers with streams of profanity when they don't meet their goals. And on a couple of occasions he has thrown full Diet Coke cans in the direction of subordinates to express his displeasure. His behavior has contributed to a high turnover rate among Real's management team. Recently, the company hired its third chief operating officer in four years, and it is searching for its third chief financial officer. In 1997, Real's directors were so concerned about turnover that they brought in a management consultant who worked with Glaser to tone down his behavior.

Glaser says the meetings helped. These days, he tries to be more sensitive to the effect he has on

subordinates. Jim Breyer, a Real director and a venture capitalist with Accel Partners, says Glaser's management style has improved: "He's a better CEO today than he was five years ago." But it is not clear that Glaser has changed substantially. Current and former Real executives say outbursts are still commonplace. "Real has a dysfunctional internal culture because of Rob," says ex-Chief Technology Officer Philip Rosedale, now the chief executive of San Francisco's Linden Labs, who still keeps in touch with Real managers.

Glaser is not easy to typecast. He's as likely to charm as to fly off the handle. A co-owner of the Seattle Mariners, he often invites colleagues to join him in his seats behind the team's dugout. He built a bowling alley in the basement of Real's Seattle headquarters—and opened it up for employees to use evenings and weekends. He and his second wife, Sarah, invite pals to their downtown Seattle penthouse for all-night card games.

Glaser loves alternative music. He worshipped "grunge" rocker Kurt Cobain, who committed suicide in 1994. When Glaser gets excited—whether it's about technology or music—he launches into a rapid, stream-of-consciousness delivery that sometimes leaves listeners scratching their heads.

Glaser is an unusual mix of capitalist and liberal do-gooder. "His politics are usually to the left of Che Guevara," kids Real director Bruce Jacobsen. In fact, Real began its life as Progressive Networks, a company that hoped to deliver socially conscious programming over the Web. The company's focus shifted when it became apparent that the streaming-media technology that it had pioneered could become a nifty business on its own. But Glaser wrote into the company's prospectus that 5% of its future profits would go to charities.

At times, it is an uneasy coexistence. "He has a continuing need to demonstrate to businesspeople that he's hard-nosed and to progressives that he cares," says college friend and Progressive co-founder David Halperin. Take recent layoffs. During his student days at Yale University, Glaser had sided with unionized workers in their disputes with the administration. Yet now he is the boss, and he decided he had to do what was best for shareholders. "The responsible thing to do from a stewardship standpoint given the financial condition was to make layoffs," Glaser says. "But I didn't sleep well knowing we had to do it."

Glaser was raised from the cradle to care about social issues. His father ran a small printing business in Yonkers, and his mother was a social worker. His parents were political activists. As a 12-year-old, he handed out leaflets supporting the United Farm Workers' grape boycott. His parents sent him to the Ethical Culture Fieldston School in Riverdale, N.Y., a K-12 school with a humanistic curriculum. "It was not an entirely typical environment," Glaser says.

The young Glaser loved baseball but wasn't very good at it. So what Glaser lacked in athletic ability, he made up for in smarts. He was particularly good with numbers. His parents got him the stats-laden *Baseball Encyclopedia*. "It's probably the way I got into computers and math," Glaser says. He excelled at school and



ROBERT DENIS GLASER

Born: Jan. 16, 1962, in New York City

Education: Yale University, BA and MA in economics, BS in computer science, all in 1983.

Career highlights: Joined Microsoft in 1983, rising to oversee Microsoft Word, a popular word processor. Also launched the company's multimedia business. Left Microsoft in 1993 and a year later launched Progressive Networks (renamed RealNetworks), the pioneer of audio and video over the Web.

His first streaming media on the Net: In 1995, RealNetworks broadcast the first live event over the Web—a baseball game between the Seattle Mariners and the New York Yankees.

Politics: A hard-core lefty. At Yale, Glaser penned a political column called "What's Left" for the college newspaper. When he set up RealNetworks, he decided that 5% of the company's profits would go to char-

ity. He has since earmarked the money for social causes.

Musical tastes: Favors alternative rock bands, such as Foo Fighters and the Posies. The band that has touched him the most: Nirvana. "It has an undercurrent of raw emotion, wrapped with this cynical indifference," he says. His music collection fills about 10 gigabytes of computer storage.

Baseball: Got hooked on baseball in 1969 watching the Miracle Mets win the World Series. "Baseball is like any religion: It tugs at you through life," Glaser says. He's now part-owner of the Seattle Mariners.

Bowling: Glaser wasn't much of an athlete growing up. He did excel at bowling and as a teen once rolled a 231. Last year, he built a two-lane alley in Real's basement. He joined with former Microsoft colleagues to buy the Professional Bowlers Assn.

Family: Married his second wife, Sarah, last summer.

started learning about computers when he was in first grade.

Glaser's academics carried him to Yale in 1979. Immediately, he fell in with the left-wing crowd. The government had just revived a requirement for young people to register with the Selective Service system, but Glaser refused. He participated in anti-draft and disarmament demonstrations and penned a column for the university paper called "What's Left."

But if he was a lefty by day, he was a

icrosoft made to run every PC. Every time a personal computer is sold, Microsoft makes money, Glaser said. "He saw how important it could be," college friend Peter Rubin says. At the same time, he told friends that he hoped that he could help progressives get access to technology—the means of production in the Information Age. Glaser packed his Toyota and headed west.

Glaser was the archetypal Microsoft employee: supersmart and hyperaggressive.

He took to the Darwinian school of corporate survival. In fact, some Microsofties say he was too aggressive, even for Microsoft. "Everyone at Microsoft thought he was very, very bright, but no one wanted to work with him," says a former colleague, who recalls phone calls in the wee hours from Glaser demanding status reports. Even so, Glaser quickly became a star. He worked on Microsoft Word, moved to the company's networking group, and eventually became vice-president of the multimedia systems group.

After a decade at Microsoft, Glaser was ready to build a company of his own. In the fall of 1993, he hooked up with his college pal Halperin. The

pair dreamed big and came up with an idea of creating a culturally progressive media company—something of a cross between MTV and the Public Broadcasting System. But it quickly became clear that it was their technology, not their plan for a new media company, that would get funding from investors.

From the beginning, Glaser knew that Microsoft would ultimately be his enemy. But he tried to buy time. Real cut a deal with Microsoft to distribute its RealAudio Player with every copy of Internet Explorer in 1996. Within a year, Microsoft was beginning to recognize the potential of streaming media and plunked down \$75 million to buy Real competitor vx-treme Inc. Glaser quickly persuaded Microsoft to pay \$30 million to license Real's audio and video technology and embed it in the Windows Media Player alongside its own technology. Eventually, Glaser thought, Microsoft would attack. But the

longer he held off the assault, the better chance Real had to survive it. "Rob got the better of Bill," says David B. Yoffie, a professor at Harvard Business School.

By the summer of 1998, though, it was a shooting war. Glaser was getting reports that the latest version of Windows Media Player was automatically replacing or disabling Real's playback software. Just weeks earlier, the government filed its antitrust case against Microsoft. Now, foes such as Senator Orrin



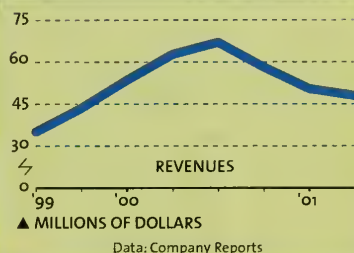
Hardball: Seattle Mariners' coach Lou Piniella and Glaser

geek by night. "Rob had a double life," says college friend Halperin. "At night, he'd sneak off to a computer lab, where a whole different thing was going on." Glaser was hammering away, building a tiny computer-games company. By his senior year, when most students didn't even have a computer, Glaser paid to get a data line into his dorm room so he could dial into Yale's network and get onto online bulletin boards. Glaser graduated with three degrees: a BA in computer science, another in economics, and a master's in economics.

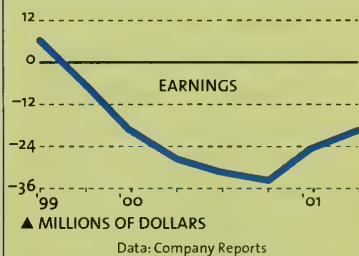
True to form, he took the career path less traveled. After graduation, he considered going to graduate school, working for tech-industry graybeard Hewlett-Packard Co., or signing on with a little-known software company in Seattle called Microsoft. His friends never expected him to choose Microsoft, but Glaser told them about MS-DOS, the software program Mi-

A SLUGGISH ECONOMY TAKES ITS TOLL ON REALNETWORKS

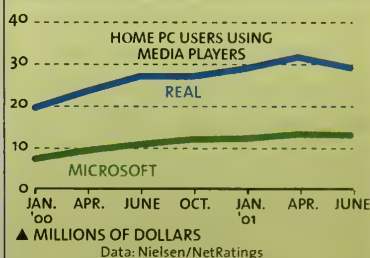
Revenues are falling because of depressed software sales...



...Keeping earnings in the red...



...But RealNetworks is still fending off Microsoft.



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G. Hatch (R-Utah) were eager to uncover more Microsoft transgressions. Hatch pressed Glaser to testify at a Senate Judiciary Committee hearing.

It was perhaps the most difficult decision of Glaser's life. While at Microsoft, he had found a kindred spirit in founder Gates. The Microsoft chairman hosted the bachelor party for Glaser's first wedding. So when their business relationship went sour, Glaser offered to talk things over with Gates before he was to testify before Congress—hoping Microsoft would make changes that would eliminate the technical problems with Real's software. After a few brief e-mail exchanges, Gates shot him down. "I've decided that it doesn't make sense for us to meet. I'm not very familiar with our relationship," Gates wrote.

Glaser was devastated. "I really wanted to resolve this situation privately and amicably. And I lamented they weren't able to," Glaser says. Two weeks later, he put on a gray suit, marched up to Capitol Hill, and said to a packed hearing room: "Microsoft is taking actions that create

Glaser says that since the appellate court ruling, computer makers have become more open to installing Real's software on their PCs, although Real hasn't inked any new deals yet.

Those agreements will be critical for Glaser to prevent momentum swinging over to Microsoft. And this would be a particularly inopportune time for Real to lose its grip on the market. The potential for delivering video and music on the Web has just begun to be realized. But broadband has been slow to develop, and that has stunted Real's growth. "They've got the best surfboard, and they're great surfers. But they're still waiting for the wave to come in," says Lehman Brothers Inc. analyst Michael Stanek. That won't happen for at least two or three years, which gives Microsoft more time to gain strength.

All the more reason for Glaser to forge into new businesses. Fortunately for him, he has a knack for spotting opportunities before others do. With GoldPass, he has built a rapidly growing subscription busi-

The warrior: "Microsoft is [creating] obstacles to the freedom...of the Internet"

ness on the Web. And it was Glaser who had the idea—and the skills—to broker the deal with three fiercely competitive recording labels to launch MusicNet, potentially one of the most promising new Net businesses. "Rob was so smart that he could bridge the different interests," says Thomas Middelhoff, CEO of Bertelsmann, one of the partners.

The odds may be stacked against Glaser. With the economy foundering and Microsoft breathing down his neck, he's facing his biggest challenge to date. If worse comes to worst, he could follow the Netscape strategy and turn to AOL to buy the company, but Glaser doesn't expect to need a bailout. Like his boyhood heroes, the Mets, he thrives when competitors underestimate him. And Glaser just might be able to pull off a bit of a miracle, too.

Glaser's relations with Gates and Microsoft never recovered. Glaser tries to shrug off the break. He acknowledges that he once looked up to Gates—"the way you look at someone when you're 21 and they're 27 is that they seem like Methuselah to you." But he insists that he's over it. "I think I look at the world pretty differently now," he says. His friends, though, aren't so sure. "Rob respects Bill almost more than anybody in the world—even now," says college chum Rubin. While Glaser has since aligned himself with the anti-Microsoft faction led by AOL and Sun Microsystems Inc., people who know him well say he still wishes he could regain Gates's approval.

With the imminent arrival of Windows XP, Glaser's relationship with Microsoft is once again in the spotlight. This time, Glaser has the government squarely behind him as the battle commences.

With Steve Hamm in New York and Jack Ewing in Frankfurt

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For a Q&A with CEO Rob Glaser, visit ebiz.businessweek.com.

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*Bear David Tice markets skepticism
—and sinks his claws into Wall
Street's overly positive research*

Making

David W. Tice has a reputation for analyzing anything that comes his way. Just ask 15-year-old daughter Abby. When she was five, her father helped her set up a lemonade business. "Dad would sit and analyze the best time of the day and what the best location for the lemonade stands would be," she says. Abby set up her lemonade concession on

Saturdays along the bike trails winding through Dallas. Little wonder that she ended up making more pennies than most other kids in her neighborhood.

The analysis Tice gets paid for earns him far less adoration than he got for his lemonade advice. Tice is a professional stock-market bear. He writes scathing research reports, which he sells to institutional investors, detailing why the stocks of some companies could be headed for a fall. He also runs a mutual fund called the Prudent Bear that sells stocks short. While the typical investor wants to buy low and sell high, short-sellers do the opposite, borrowing stock and selling it at a high price and then buying it back cheap after the price falls. Because he bets that a stock's price will tank, Tice benefits from the misery of others. "Whenever we make money, lots of others lose money," he says.

Being a bear is paying off these days. Over the past year, the Prudent Bear Fund has racked up a return of 35% while the Standard & Poor's 500-stock index has tumbled 19%. That puts Tice among the top 1% of all fund managers over the last 12 months. His fund is up 3% in 2001, while the S&P is down 10%. Lately, his gains have been tempered because brief market rallies have forced him to cover short positions and take losses in stocks, such as telecom equipment maker Juniper Networks.

His research is getting more popular,



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Bad News Pay

too. His client list has increased 40% in the last three years, to 200 people. While his "Behind the Numbers" service is still much smaller than most investment newsletters, he charges \$15,000 a year, about 15 times the price of a high-end newsletter. He takes pride in being a reality check on Wall Street analysts, who are coming under fire for producing overly

Tice finds his targets by playing the role of a sleuth, going over balance sheets, income statements, and cash-flow statements with a fine-toothed comb. He looks for misleading numbers or bogus information that, once uncovered, will cause a stock to tumble. His analysis is almost always the opposite of Wall Street's. For example, Tice warned his clients in 1996

into Tyco's acquisition-related charges. In June, 2000, Tyco said that the SEC's Corporation Finance division had requested, following review of a Tyco securities registration, that the company make several changes to its financial statements. The changes were essentially a wash, reducing diluted earnings per common share, after non-recurring charges and credits, by two cents in the first quarter of fiscal 2000, and increasing the same earnings per share number by two cents in fiscal 1999. Tyco's stock surged 13% the day of the announcement. In July, 2000, Tyco said the SEC's Enforcement Division had ended its inquiry without taking any action.

Both sides have claimed victory. Tice, who says he doesn't short stocks before he issues new research and was not shorting Tyco's stock when he made the report, says he feels vindicated because the SEC asked Tyco to restate financials. Maryanne Kane, a Tyco spokeswoman, says the restatements were "a completely

Over the last year, Tice's fund is up 35%—while the S&P has tumbled 19%

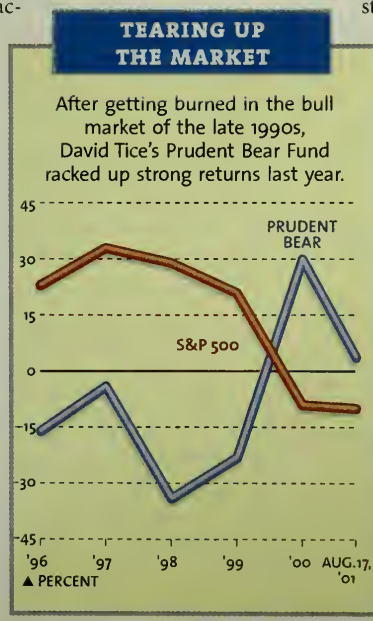
positive research to boost their investment-banking business. "I feel particularly responsible about warning people that there's a cliff down below, and Wall Street will never say that," he says.

Gobbledygook. Despite the stock market's decline over the past 18 months, he thinks there's still a cliff ahead. About 75% of his investments are short bets, he says. Among favorite targets these days are top tech players, including Amazon.com, Yahoo!, Dell Computer, and eBay. He thinks some, including Dell and eBay, are good companies that are simply overvalued. For example, he says analysts have been egging on investors to buy Dell stock at a lofty 35 times their estimate of 2003 earnings. He calls the estimates "gobbledygook" because a price war among PC sellers will hurt profits. By contrast, he thinks Yahoo still needs to prove it has a legitimate business beyond being an Internet portal dependent on online advertising. Many continue to consider Yahoo a strong growth company, but Tice calls its operating performance "horrific," with 2001 revenues likely to be 35% below last year's. "If it's a growth company, how come it's more cyclical than General Motors?" he questions. Yahoo didn't return calls seeking comment.

that special charges at then-soaring Sunbeam Corp. were concealing underlying problems at the business. In 1998, the company restated its financial results and CEO Albert J. Dunlap resigned his post. Sunbeam declined to comment.

But critics argue that Tice sometimes overreaches. In October, 1999, Tice wrote a report that questioned conglomerate Tyco International Ltd.'s accounting practices, particularly its frequent use of one-time charges related to acquisitions. That led to a 23% drop in the company's stock in one week. In a conference call, Tyco CEO L. Dennis Kozlowski blasted Tice's research as "false and misleading" and vowed "there are no restatements coming from Tyco." In December, the Securities & Exchange Commission's Division of Enforcement opened an inquiry

pletely separate matter" from Tice's allegations, which have "proven to be unfounded." The SEC declined comment. Tyco's stock was 1% above its level the day before Tice issued his report, while the S&P 500 has dropped 9% over the 22-month period. That performance helped Tyco rank No. 1 this year on *BusinessWeek's* BW 50 ranking of top-performing companies. No question, the late 1990s were



rough years for Tice. As the bull market galloped ever higher, Prudent Bear was hit with negative returns of 34% and 23% in 1998 and 1999. Tice, like many others, kept guessing that stocks were overvalued only to see them rise higher. Many shorts closed shop, reducing the field from 25 managers in 1990 to six at the end of the decade, according to Harry Strunk, a Palm Beach (Fla.) investment consultant who tracks short-only managers.

Sanity Check. Whether Tice is right or wrong about a stock going down, clients value his insights. Monica Graham, a partner at the New York hedge fund Graham Partners, thinks Tice is one of the most talented analysts she has ever worked with. "For me, he is a sanity check at a time when it's easy to be swept away by all the euphoria," she says. Bob Holmes, who runs hedge fund Gilford Partners in Chicago, values Tice's deep analysis of financial statements. "David sees the company's fundamentals deteriorating, but the stock continues to ramp up as it takes time for the rest of the world to discover it," he says.

Beware the Bear

Money manager David Tice racked up strong returns in 2000 betting against top tech companies. Here's a sampling of companies he thinks are headed for a fall this year.

amazon.com Tice has been bearish on the e-tailer since 1997, and finally made big money last year when the stock dropped 80%. He thinks Amazon manipulates its earnings numbers to portray its performance in the best possible light. For example, as growth has stalled in the company's books, music, and video category, Amazon has pointed to its consumer electronics business as the driver of growth.



Tice has been wrong about AOL for years, but he's not giving up. AOL cited free cash flow of \$651 million in its first quarter this year, even though Tice argues cash flow was only \$70 million after it paid to settle a lawsuit related to Time Warner's sale of Six Flags entertainment parks. AOL says his interpretation of the numbers is wrong.



Tice admits to being impressed by the continuing strong growth at eBay. Still, he thinks an "ever onward and upward" optimism has resulted in an overvalued stock, with shares trading at 180 times estimated earnings for 2001 and 100 times 2002 earnings estimates. eBay hasn't shown signs of faltering so far: its stock is up 94% for the year, to \$64.



Even after the stock of the top Internet portal collapsed last year by 86%, Tice is bearish on Yahoo's prospects. He says it's valued as a growth stock—and it's no longer growing. At \$17.64, Yahoo's stock trades at 350 times its estimated 2001 earnings, a very high price-earnings ratio. Yet Yahoo's revenues are expected to fall 35% this year, and earnings are projected to slide more than 50%.

pany. He added that pro forma earnings are widely accepted.

One short position that Tice has regularly lost money on is America Online, now AOL Time Warner. In 1994, Tice released a report questioning the validity of the business, especially in the face of increased competition. "I miscalculated the power of the brand and the customer's loyalty," says Tice, who has an AOL account himself. That doesn't mean he has quit: Tice still believes that AOL is overvalued. One reason is that Internet use may be slowing. As evidence, he cites a study by researcher Telecommunications Reports International Inc. that shows U.S. households with Net access dipped for the first time ever by 0.3%, to 68.5 million in the first quarter. Another reason is AOL's accounting. The company reported that free cash flow, which usually comes from operations, was \$651 in this year's first quarter. Tice figures it was only \$70 million after the cash settlement of a lawsuit related to the sale of Six Flags Theme Parks Inc. and several other one-time charges. AOL spokesman Ed Adler says that its operations did generate \$651 million and argues that, under standard accounting rules, special charges such as the settlement do not need to be counted as expenses in the quarter in which they occur.

While investors often rip Tice apart on online bulletin boards, he says they're barking up the wrong tree: "We protect investors with our analysis. The bad guys are the brokers that were promoting the outrageous valuations of those companies," he argues. Tice recently went to Washington to make his point. On June 14, he testified before a Congressional committee chaired by Representative Richard Baker (R-La.) that is looking into the erosion in the so-called Chinese wall that has traditionally shielded analysts from investment-banking interests. Tice testified he believes the conflict of interest between analysts and investment bankers encouraged stock market speculation and pushed capital toward the tech sector at the expense of other industries.

Tice attributes his skepticism to his Missouri upbringing. "It's a show-me state where we aspire to be as fiercely independent as Harry Truman," says Tice who, like Truman, was raised in Independence. These could just be the days for Give 'Em Hell David Tice. •

Data: David W. Tice & Associates, Bloomberg Financial Markets



bandwidth

raised to the power of El Paso



The transformation of sand to glass to fiber optics is complete. The transformation of fiber optics into the multi-billion dollar telecommunications industry has just begun. That transformation will change the way we work, the way we play, the way we think. Of course, changing the way the world works isn't child's play, as any telecommunications service provider can tell you. The power of your partnerships is critical to your success. That's why El Paso Global Networks offers our partners a whole new model of customer service. A model that includes the best wholesale data telecommunications product suite on the market, seamless end-to-end connectivity provisioned at the speed of light, and innovative product development.

We also understand that it takes more than superior service to transform an industry. It takes commitment and insight. At El Paso Global Networks, we're committed to powering the transformation through our Strategic Investment Fund to help you speed new products and services to market, so you can offer your customers the latest technology. And as a leader in bandwidth trading, we have the industry insight to help you manage risk, analyze options, and shape strategy. Join us in the transformation and raise your company to the power of El Paso.

El Paso Global Networks. Bandwidth. Raised to the power of El Paso.



eSpeed's Trading

Cannibalizing Cantor's bond trading has paid off, but growth is slowing

In the 105th floor of New York's World Trade Center, a bond broker is sleeping, legs stretched out, head resting softly on the back of a chair. When he's awake, he takes phone orders for U.S. Treasury securities at Cantor Fitzgerald, once the leading wholesale broker of government bonds. Two years back, he would have been surrounded by 220 screaming comrades hard at work matching buyers and sellers. Now, he's one of just 25 brokers whiling away the day and waiting for the phone to ring.

The new center of action lies down the hall at eSpeed Inc. In March, 1999, Cantor spun off eSpeed, an electronic marketplace for bond trading, in a bid to reinvent the brokerage as an e-business and prevent online upstarts from siphoning off trades. Cantor has kept its equity brokerage, which the company says remains healthy. But most of its bond trades have moved over to eSpeed—in which Cantor holds a 55% stake. In the upstart's offices, computer screens silently record billions of dollars in bond and commodity trades every hour with almost no human intervention. "Nobody believed we could go electronic so fast," says Tim Coughlin, Cantor's head of government bond trading.

While most e-marketplaces are in a financial tailspin, eSpeed has been gaining altitude. The company has become the de facto exchange for U.S. Treasury securities, with about half of the \$300 billion in daily trades taking place on its system. In the second quarter, eSpeed saw revenues of \$34.1 million, up 52% from a year ago. Although the company continues to lose money—\$1 million in the second quarter—executives and analysts expect it to turn profitable in the current quarter. Next year, eSpeed is forecasted to earn \$24 million on \$195 million in revenues, says J.P. Morgan Chase & Co. analyst Greg Smith.

That prospect has helped cushion its shares, which have fallen only 10% this year, to \$12, compared with the 85%+ drop of many Internet stocks. "eSpeed is going to be one of the survivors," Smith says.

Even so, the highflier may be headed for stormy weather. eSpeed faces slowing growth in its bond-brokering business as it takes an increasingly large chunk of sales from Cantor. In the second quarter, Cantor Fitzgerald completed 25% of its transactions by phone,

compared with 63% in the first quarter of 2000. That's starting to affect eSpeed: In the first half of 2001, the upstart's trading volumes grew less than the overall Treasury market for the first time—by 11% vs. 33% for the total market. Within 18 months, eSpeed will have taken everything it can from Cantor, says Robertson Stephens Inc. analyst Justin J. Hughes.

eSpeed may also suffer from slowing action at the Federal Reserve. Since January, the Fed has cut interest rates six times, which makes the government bond market more volatile and boosts trading. As the Fed slows rate cuts, analysts say eSpeed's trading volumes will shrink. "A dull market is not a good thing," admits eSpeed President Frederick T. Varacchi.

Another red flag: Howard W. Lutnick, the 39-year-old chairman and chief executive of both eSpeed and Cantor Fitzgerald, has had run-ins with the Securities & Exchange Commission. In 1994, while Lutnick was president of Cantor, the SEC fined the firm for improperly funneling the brokerage's bond trades through small investors' accounts. The firm paid a \$100,000 fine but didn't admit any wrongdoing. Then, this past June, after an SEC investigation of eSpeed's accounting methods, the company agreed to amend its financial statements. The issue: The SEC believed eSpeed overstated revenues by

Secrets

A man with glasses and a dark jacket is leaning on a windowsill, looking out at a city skyline at dusk. The word "Secrets" is written in large, bold, italicized letters across the top left. The man's hands are clasped on the windowsill. The background shows a city skyline with a prominent skyscraper, likely the Empire State Building, under a twilight sky. The lighting is warm and dramatic, with the man's face partially in shadow.

**CEO Lutnick:
Worried about
slowing Fed action?**

including charges billed to Cantor for processing trades. The change doesn't affect profits, but it takes a bite out of revenues. In the first quarter, eSpeed had to cut its reported revenues by 26%, to \$31.9 million. Still, most analysts aren't concerned. "We don't think it changes the economics of the situation," says analyst Diane B. Glossman of UBS Warburg. Lutnick

agrees, calling the affair "simply a presentation change."

Lutnick is a classic Wall Street overachiever. He grew up in a middle-class home on Long Island, the son of a college professor and an artist mother. His mother died when he was 16, and his father passed away during Lutnick's first week at Pennsylvania's Haverford College. Upon graduating with a degree in economics, Lutnick joined Cantor Fitzgerald, founded by B. Gerald Cantor. A onetime Yankee Stadium hot-dog vendor who later amassed a \$500 million fortune and the world's largest private collection of Rodin sculptures, Cantor took a liking to Lutnick. Under Cantor's guidance, Lutnick prospered, and he soon viewed Cantor as a surrogate parent. In 1991, Cantor made Lutnick, then 29, president of the firm. The two ran Cantor together for the next five years. "He was my family," Lutnick says,

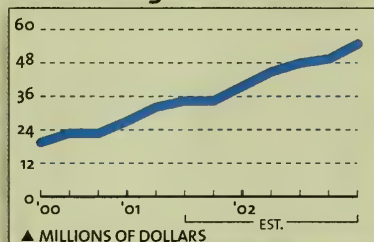
Lutnick's bold move. "In the high-tech business, the rule is to cannibalize yourself before anyone else cannibalizes you," says Michael Cusumano, a professor at Massachusetts Institute of Technology's Sloan School of Business.

To keep eSpeed growing, Lutnick has created an online supermarket of wholesale commodity exchanges. So far, he has built 48 marketplaces for everything from foreign exchange to Eurobonds to electricity. "The world is going to trade these commodities like it trades stocks," says Lutnick. "And eSpeed wants to be the place where that happens."

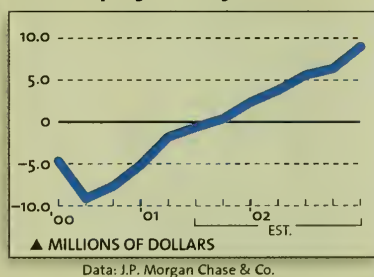
Insurance policy. So far, he has met with mixed success: Trading of products other than Treasuries has grown to represent about half of eSpeed's revenues. eSpeed, though, is unlikely to dominate many of those markets the way it does

Bumpy Road

eSpeed's revenues are climbing...



...while it creeps toward profitability



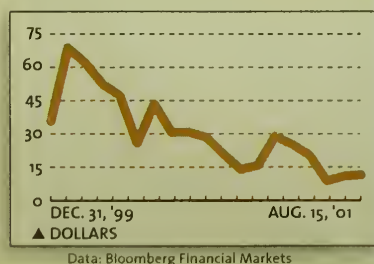
Analysts see progress...

RATINGS ON ESPEED

AUGUST 2001		JANUARY 2001	
Strong Buy	5	Strong Buy	3
Moderate Buy	4	Moderate Buy	6
Hold	1	Hold	0

Data: Bloomberg Financial Markets

...but investors remain unconvinced



An SEC ruling forced a cut in revenues this year, but analysts aren't concerned

glancing at the four-foot-tall portrait of Cantor hanging behind his desk.

Like many families, Lutnick and Cantor had their share of disagreements. In the early 1990s, Lutnick wanted to push into electronic trading. But, he says, Cantor feared the move would hurt the brokerage. "It is very hard when it is your baby to make those tough decisions," says Lutnick. Meanwhile, Cantor's health was declining due to diabetes, and in January, 1996, he was put on life support. Cantor's wife, Iris, tried to take over the firm, Lutnick says. In response, Lutnick convened a five-member incapacity committee provided for in the brokerage's partnership agreement and was granted control of the company. Since then, Mrs. Cantor and Lutnick have been engaged in intense legal warfare, suing each other over issues ranging from funding for a foundation she heads to a dispute over payments from the spin-off of eSpeed. Through her attorney, Barry Slotnick, Iris Cantor declined to comment.

With control of Cantor Fitzgerald, Lutnick was free to push the brokerage into the e-future. He invested \$250 million in an electronic trading system. In March, 1999, realizing that Cantor brokers had no incentive to make the switch to electronic trading, he created eSpeed. Outsiders laud

the U.S. Treasury trading that it pioneered. More than 70 companies have built electronic exchanges for fixed-income securities. The biggest threats: Garban-Intercapital PLC and Tullet & Tokyo Liberty PLC, two London brokerages with electronic-trading operations. Tullet is strong in emerging markets and Garban is the dominant player in many of the more esoteric markets that eSpeed is trying to attack, such as foreign government bonds. While eSpeed rules in U.S. Treasury securities, "they are not the largest broker of any other instrument," says Michael Spencer, CEO of Garban.

Lutnick acknowledges that he faces plenty of rough patches on the road ahead, but he remains optimistic. In his capacious corner office adorned with a Rodin sculpture, Lutnick predicts 50% annual growth through 2002. Clearly, eSpeed's connection to Cantor is a unique insurance policy, assuring it won't end up in a dot-coma. And Lutnick can draw confidence from his past success and eSpeed's strong start. Considering the challenges ahead, however, Lutnick may want to fasten his seat belt for a bumpy ride. ●

e.biz online

For a Q&A with eSpeed CEO Howard Lutnick, visit ebiz.businessweek.com.

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By now, most companies use the Web to connect with their employees, their customers, and their suppliers. The race to connect is over. So what happens now?

Many e.biz observers agree that the next phase will be one in which innovation, not technology, rules the day. In phase two, companies figure out how to use technology to drive better customer relationships, create new revenue streams, offer innovative services, and generate greater efficiencies. In short, companies become "Web smart."

The emerging strategies, rules, and results of this new phase were the topic of Web Smart: Better Ideas, Measurable Results, the latest edition of BusinessWeek's acclaimed e.biz Live series. Held June 7-8 in London, UK, the event sought to identify Web-smart companies and examine their best practices in six key Web-smart categories: streamlining procedures; revolutionizing marketing and customer service efforts; transporting goods more efficiently; and introducing ingenious products and services.

Underlying all of these efforts, of course, is a new breed of executive who can change with the times and inspire their teams to do the same. For at the end of the day, a Web-smart company starts with Web-smart management.

Streamlining

Streamlining was one of the first widely adopted uses of the Web, and



with good reason. By putting existing procedures online, a company could engineer instant improvements in speed and productivity. Today, companies are also enjoying some unexpected benefits.

"When your employees are using Web-based browsers and applications every day, they think about solving customer problems the same way," says **Dick Gillespie**, vice president of Cisco Systems, Inc.'s UK and Ireland divisions. "So by building this Web-based infrastructure, you can actually make your organization more effective, serve your customers better, and your employees become more productive at the same time. It's a surprising thing that comes out of something that begins as a way to save costs."

Fringe benefits aside, streamlining remains primarily a cost-saving technique. Everyone agrees that the monetary benefits can be immense. Actually quantifying these benefits, however, can be surprisingly difficult. **Bill Echikson**, BusinessWeek's Brussels correspondent, commented on this phenomenon. "You hear that there are billions of dollars saved. But when you try to get the hard facts or the reasoning behind these predictions, you often come away very confused."

Part of the problem is the surfeit of data available today. As **Peter Fader**, associate professor of marketing and director of the Wharton School's Web metrics program, points out,

Written by
Kris Hirschmann

Web Smart Management

"The big trends in information technology over the last few years have been things that make strategies more alike rather than more different," says **Gary Hamel**, author of *Leading the Revolution*. "But at the end of the day, the only thing that counts about strategy is where it's different. Where does it alter the basis for your competitive advantage within your industry?"

To generate competitive advantage in the modern age, says Hamel, a company must focus not on technology but on innovation. "The question is not where is the 'e,' but where is the 'i'? Where is the real innovation in your 'e' things? Because radical innovation is the only way you can create truly new wealth in today's world."

How does a manager create an atmosphere that encourages such innovation? "Teach your people to be alert to opportunities. Show them how to be contraries and heretics. And make sure they spend enough time out on the fringes, where the new things are happening. People who innovate constantly put themselves out on the bleeding edge where technological and social and regulatory change are taking place, so they see earlier the revolutionary potential in the things that are already changing."

Gary Hamel, author, *Leading the Revolution*, delivers his thought-provoking keynote address on "Web Smart Management," which opened the e.biz Live: Europe Conference



The Web Smart Roundtable, panelists from left to right: Scott Shuster, conference chairman, Gary Hamel, Dick Gillespie, Mike McNamara, Alfonso Di Ianni, Sam Taylor, and Antti Viitanen



"Companies have all this data now, and they want to do something with it. They're demanding metrics." In response, metrics providers have invented a slew of new formulas. But these formulas, says Fader, are largely meaningless. Rather than coming up with new ways to crunch numbers, companies should look to proven metrics, regardless of their originating industry. "The metrics that exist in seemingly unrelated industries can be very informative, because consumer behavior is surprisingly similar across different categories."

Marketing

Executives are finding that consumer behavior is also surprisingly similar across different channels, including the Web. In fact, companies today are realizing that the Web is not the magic bullet of success they once imagined it to be. Instead, it is just one more way to reach customers. As **Alfonso Di Ianni**, senior vice president of marketing for Oracle Corporation, says, "Successful companies see the Web as just another channel rather than the only channel. It's very important not to think of e-marketing as one and only one piece. It must be connected with sales and services, and the other pieces of the organization as well."

The Web may be just another marketing channel. But it's an important one—so important, in fact, that it may dictate a company's products and services. "When entering a new channel

such as the Internet, you must make some serious strategy decisions. Just taking what you've got and spreading it into new channels may not be the right answer," says **Chris Voss**, foundation chair in management, technology, and learning, and deputy dean of the Long Business School. "You may need to redesign your products or services, or indeed even your business model, for the multi-channel environment."

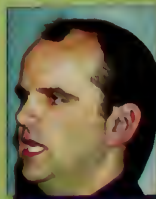
Customer Service

BT Ignite, Content Hosting is one company that has undergone just such a redesign. "The portfolio of services that customers expect from a hosting company has expanded dramatically. To meet these needs we have had to expand our capabilities and offer a much broader product set," explains **Richard Wigley**, the company's vice president of content distribution networks. BT Ignite, Content Hosting is also focusing on great customer service—a key differentiator in today's business world. As Wigley says, "We're successful because we listen to the customers and take the time to understand not only their requirements but their customers' requirements as well. We then help them to understand how we're going to solve their immediate problem and how we're going to help their business grow. We have a unique set of capabilities, and we leverage that."

Lands' End, Inc. is another company with a reputation for intense customer

e.biz Live: Europe

"We want our customers to succeed, and since success requires internal management, we want to manage their intranet as well as their extranet." —**RICHARD WIGLEY**, vice president, content distribution networks, BT Ignite, Content Hosting



ens. Consistent with this philosophy, the company embraced the Web early in response to customer demand. The result has been a series of industry-transforming customer service tools. We have been very innovative on the Web, and because of that innovation we have received a lot of accolades in the press," admits **Sam Taylor**, vice president of the company's international division. At Taylor emphasizes attitude over achievement: "What has driven innovation is listening to our customers. Regardless of the channel, world-class customer service is still about listening to the customers and understanding their needs, then meeting them."

Loving the Goods

no matter how great its customer service, a company's e-commerce initiatives will fail if the goods are not delivered on time. Moving the goods is thus a primary concern for Tesco.com, the online grocery division of Tesco plc. The company utilizes the Web to run a simple, beautifully efficient picking and delivery system. **Mike McNamara**, CTO of Tesco.com, explains how the process works: "Customers enter orders on the Web. That list is received by the local grocery store and transmitted to a trolley-mounted PC, which is wheeled out to the shop floor. The picker gets the product. When the picking is complete, the product is loaded onto a van and the driver delivers the goods to the customer. The only piece of paper in the whole process is the customer's till receipt." At Tesco.com, the Web is an essential and valuable piece of the product delivery chain.

Products

The Web does not simply facilitate the delivery of existing products and services, it also enables entirely new ones, such as Web-based mobile services. The possibilities for such services seem endless. As **Antti Viitanen**, vice president of product, Sonera Zed, says, "Only our imaginations limit what can be done with mobile. Your phone will be your TV. It will be your light switch. It will be your gaming device." Those things, however, are still in the future, and shaking them now would be a mistake: people are not going to get this service on their phones for quite a while, and it's wrong to build their expectations. We need to allow customers to become sensitive about mobile services, and that may take some time."



Conference delegates networking during a break

Though it may take time, everyone seems to agree that it will happen. Companies are therefore positioning themselves to take advantage of the coming explosion. Paybox.net, which enables mobile payments via cellular phone, is one such company. "Mobile payment is something we are absolutely certain is happening," says **Mathias Entenmann**, the company's founder and CEO. But when? "We really don't know how fast it will happen. It might take three, five, or even ten years. All we know is we have to be ready."

A New Boom?

Entenmann's optimism is increasingly typical. Once cowed by the dot-com crash, businesses today are expressing renewed faith in technology. An interactive audience poll bore witness to this reality: Over 95% of attendees felt that the Internet bust was partially due to overreaction and that technology was on the rebound.

Given the changing attitudes, many analysts are asking whether industry in general is heading for a new boom. But **Andy Bailey**, associate director of venture marketing for Interregnum plc, believes that's the wrong question. "I don't think we were ever really out of a boom. It's just a matter of perspective," he says. "Even after the so-called crash, the information technology industry is still the largest and fastest-growing industry on the planet."

In some ways, the industry may even be healthier than it was in the pre-bust days. As **Julie Meyer**, cofounder of First Tuesday and founder/CEO of Ariadne Capital, points out, "Companies have a greater opportunity today because the 'noise factor' is gone. They can focus on the business rather than having to participate in the hype." Even the losers in the dot-com shakeout,

Diving Into the Knowledge Pool

At Siemens AG, a Web-smart e.biz initiative began with the realization that times—and customer attitudes—had changed. "Our customers more and more were asking for our knowledge, not just our hardware and software. And we knew that a knowledge-based business could not be run from one centralized location. We had to involve all of our local companies around the world," says **Joe Döring**, president, information and communication networks, business transformation and coordination, Siemens AG. "Most importantly, we had to find a way to learn what we really knew."

The answer was ShareNet, an electronic network of executives willing to swap expertise with their global colleagues. Launched in 1998, ShareNet today connects 15,000 Siemens employees in 160 countries and enables them to tap each other's experience and knowledge. By doing this, says Döring, "We avoid reinventing the wheel every time a new business case appears. That saves us money. But even more important is the fact that we have set up a new spirit in the organization."

Joe Döring, president, information and communication networks, business transformation and coordination, Siemens AG, enlightens conferees with his case study on knowledge management



"The winning formula is not building a proprietary solution. Rather, it is slowly but surely setting an industry standard and integrating partners into a strategic network."

MATHIAS ENTENMANN, founder and CEO, Paybox.net



"I find it troubling when people look at the dot-com crash and draw inferences about e-commerce. The two have nothing to do with each other."

PETER FADER, associate professor, marketing, and director of the Web metrics program, The Wharton School, University of Pennsylvania



"We're channel agnostic. We leave it up to our customers how they want to shop from us; we don't try to migrate them from the catalog to the Web."

SAM TAYLOR, vice president, International, Lands' End, Inc.



"Sustainable profitability is going to be quite low for a company that doesn't streamline using the new technologies."

DICK GILLESPIE, vice president, UK and Ireland, Cisco Systems, Inc.

"We build our physical shops where all the people are. So with the store picking model, our delivery times are very short."

MIKE McNAMARA, chief technology officer, Tesco.com



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RETHINKING THE INTERNET

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Chicago, Illinois

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visit our Web site at

www.conferences.businessweek.com

she says, are reaping benefits: "With the kind of mainstream failure that occurred during the first Internet boom-and-bust cycle, it's difficult to take the same view of failure. We now understand that the most important thing is the process of learning."

That understanding may, in fact, be the foundation of "Web-smart" e-business. In a time of constant change, the willingness to learn has become an essential leadership trait. According to **Jay Conger**, professor of organizational behavior at the London Business School and author of *Building Leaders*, "All leaders have to be chief learning officers. We are in an extended period of change that is all about things we could not have expected. If our senior leaders aren't highly adaptive and great models during this period, then our companies won't adapt either, because ultimately leadership is about being a role model. Are your actions sending the right message to your employees?"

With this statement, Conger captures the essence of today's successful business. By their example, change-friendly leaders create an atmosphere that encourages employees to develop new and better uses for a company's technological resources. Web-smart management thus becomes a self-fulfilling prophecy that does, indeed, give birth to the Web-smart business.

e.biz POLL RESULTS

E-business and my company

Yes, e-business has led to significant change in the way my company is organized and/or led, and it is change for the better.

Yes, significant change — for the worse.

Some change, but not significant.

Very little change in the way our company is run or led.

My company's investment in e-business...

is enormously successful, cutting costs and/or earning profits that have had significant positive impact on our accounts.

is considered successful because it has improved operations and/or created a new marketing channel, but it has not greatly improved company performance.

has had little financial impact, but at least it hasn't cost us much.

is a big fat money loser. We're still looking for a way to make the Web make money.

Interactive polling provided courtesy of
MERIDIA Audience Response Service
Plymouth Meeting, PA

BusinessWeek

| **Events**



BY ROBERT D. HOF

rob_hof@ebiz.businessweek.com

Broadband Baloney

High-speed service may sound good, but it's nowhere near the Net's cure-all

As the growth of the Internet flags, the people who run struggling online media, e-commerce, and networking companies think they have identified the elixir to revive it: broadband. From Cisco Systems and Intel to Sony and Yahoo!, they're all betting that high-speed Internet service will spur multimedia ads, snazzy video, and the ability to make impulse purchases—thereby getting

more people on the Net to spend more time and more money. Unfortunately, it's a bad bet.

Let's face it, most people simply won't get high-speed connections at home for years to come. Blame the steep costs of installing high-speed lines, clumsy regulatory rules, or the poor economy, but broadband has been slower to take off than expected. Market watcher Forrester Research Inc. estimates 72% of dial-up Net access customers won't pay more than \$25 a month for broadband—half of what most providers now charge. As a result, fewer than 5% of U.S. online households have anted up. Intel Corp. Executive Vice-President Leslie L. Vadasz estimates it could take a decade for two-thirds of households to get broadband.

That's just the start of the problem. Too many companies assume the Net is simply slow television and hope broadband will magically transform it into a familiar entertainment medium. But that's a wrongheaded view of the Net. It's best at activities that involve interaction, not passive viewing. "Communication is the past, present, and future of the Internet," says Eric Schmidt, chairman and chief executive of search engine Google Inc. That's why e-mail and instant messaging remain the most popular things to do online. Neither requires broadband, now or ever.

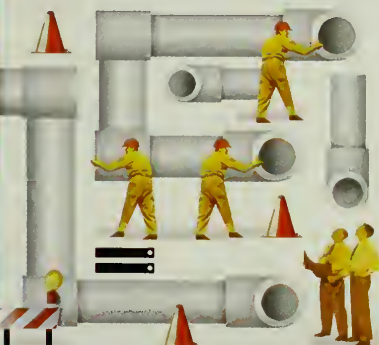
Don't get me wrong, it's not that broadband doesn't improve use of the Internet. Faster-loading pages are cool, the always-on connection is even cooler, and speed is crucial for some popular activities such as downloading music. But crucial enough to overcome all the costs and other obstacles? Not anytime soon.

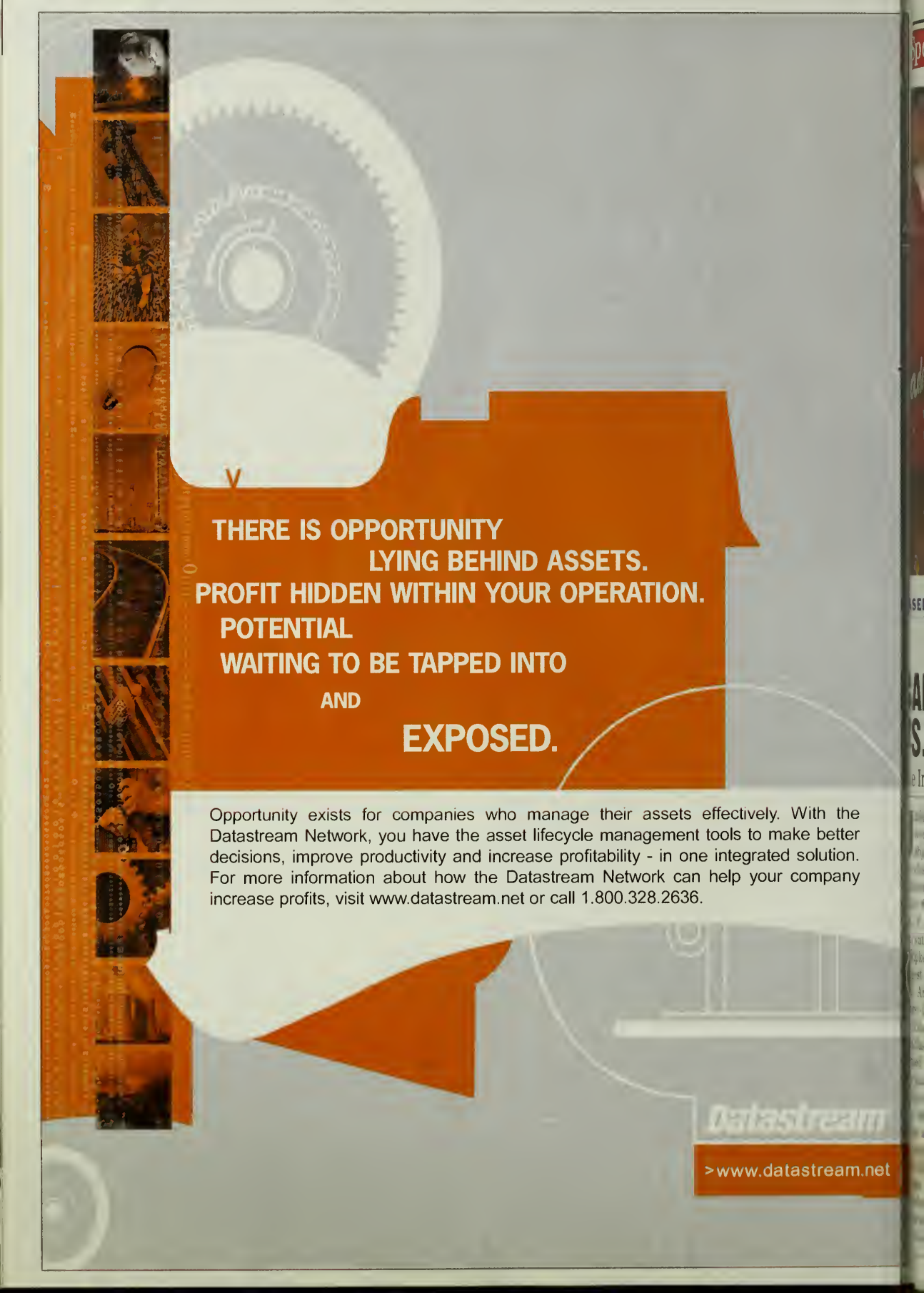
Moreover, other bit-hogging activities such as video seem unlikely to spur many people to pay for broadband at any price.

Films on my PC? Sorry, my office chair at home doesn't recline far enough. Multimedia ads? No thanks—they're just as likely as TV ads to send me to the fridge for a beer, or more likely to another site. Media companies and advertisers "still haven't found a way to make money in the narrowband world," says Nick Gould, CEO of the New York Web design company Catalyst Group Design. "How are they going to make money with broadband?"

Even if some people might want to watch this stuff on their PC, or the PC somehow finds its way into the living room, the broadband connections available today aren't nearly broad enough for video and the like. On a dial-up line, you get grainy, jerky video in a tiny window. On a DSL or cable modem connection, you get grainy, jerky video in a larger window. Technology to compress data helps, but TV-quality video on a big screen may require the same optical fiber used in commercial high-speed lines to be installed all the way to each home. By most accounts, the cost of doing that is so high it's at least 15 years away.

The thing is, tech companies and Web sites already have plenty of ways to improve the Internet experience at their fingertips. Why on earth don't we have instant-on PCs yet? How about installing more servers at sluggish Web sites? The main reason many Web pages load slowly, points out Microsoft Corp. Senior Researcher Jim Gray, is that servers are underpowered, not that Net connections are too slow. And when are PC and network gear makers finally going to create seamless links between computers and entertainment equipment? The sooner the techies quit chasing broadband pipe dreams and work on these basics, the sooner we'll get jazzed again about the Internet. •





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BASEBALL

CAL RIPKEN VS. LITTLE LEAGUE

The Ironman is out to be the No. 1 name in youth baseball

Unlike many pro athletes, Cal Ripken won't be stepping into a career abyss when his playing days draw to a close later this year. The legendary Baltimore Oriole already has laid a foundation for the next phase of his life. In fact, if you go to Aberdeen, Md., you can watch them pour the concrete.

Ripken, 41, is hell-bent on being the biggest name in American youth baseball. And he has spent the past few years devising what he hopes will be the killer brand of the pint-size set: Ripken Baseball. The future Hall of Famer formed the baseball instruction company five years ago with his kid brother, Bill, a 10-year major leaguer. Since then, the duo has run \$575-a-week overnight camps and a string of day camps where the coaches are their ex-teammates. And they're hardly stopping there.

Last October, in their hometown of Aberdeen, 30 miles north of Baltimore, construction began on the Taj Mahal of kids' baseball parks. The 56-acre facility

will cost about \$35 million—\$9 million more than first estimates. Taxpayers will kick in \$14 million, with the expectation of economic development. The rest will come from naming rights, sponsor deals, private investors—and Ripken, who will hang up his spikes after 20 years and 2,632 consecutive games. The complex will feature a 6,500-seat minor-league stadium (opening in April), six youth diamonds dressed up as classic parks (Wrigley Field, among them), and a camp/conference center with room to sleep 400.

That's a lot of bunks to fill, but Ripken thinks he has it figured out. Two years ago, he accepted a proposal from the Trenton (N.J.)-based Babe Ruth League Inc. to rename its league for 5- to 12-year-olds the "Cal Ripken Division." Now the Ripken Division's 600,000 players wear Ripken Baseball shoulder patches and are potential overnight guests at the Ripken Baseball complex.



PLAY BALL!
Players get a handshake they won't forget as the Ripken World Series starts up

Still, the Babe Ruth League, with total participation of 886,500, is far smaller than Little League Baseball Inc. in Williamsport, Pa., which claims nearly 3 million players worldwide and took in \$12.6 million in revenues in 2000.

As Ripken tells it, unseating Little League has never been part of his plan. "I don't see it as a competition at all," he says. But it sure will seem that way on Sunday, Aug. 26: The title game of the Little League World Series will be on ABC only hours after the Ripken World Series, on Fox Sports Net, crowns its 12-year-old champs in Vincennes, Ind. And next August, the Ripken World Series will be played in Aberdeen on a scale replica of Camden Yards, Ripken's home ballpark. **"THAT WAS AWESOME."** In one category, Ripken already appears to be out-Little League the Little League World Series: corporate sponsors. Corporations, many with long-standing ties to Cal, are ponying up as much as \$500,000 to sponsor the Ripken Series. Title sponsor Chevy Trucks will have outfield billboards and will air commercials featuring Ripken. Other sponsors are paying to attach their names to events, including the Century 21 Home Run Hitting Contest.

Ripken seems an improbable challenger to Little League. In 1973, he was a star on a West Asheville (N.C.) team that came close to qualifying for the Little League World Series. Little League President Stephen D. Keener declined to speak with *BusinessWeek* for this article. Replying to written questions, he wished Ripken luck with his Aberdeen complex but noted: "We certainly believe Little League is the best."

Ripken might differ on that point. So might some of the kids in his upstart league. At last year's Ripken World Series, Kyle Smith of Clovis, Calif., was voted Most Valuable Player. But Kyle's most indelible memory was of sitting across a breakfast table from Ripken. "That was awesome. What else can a 12-year-old ask for?" he says now. It's a question that Ripken hopes a few million more kids will soon be asking.

By Mark Hyman in Baltimore

BusinessWeek online

For an interview with Cal Ripken, go to www.businessweek.com.



Cover Story

WINE WAR

Savvy New World marketers are devastating the French wine industry

It's a picture postcard of La Belle France: sun-drenched stone houses perched on a hillside, a soaring Gothic church spire, ripening vineyards. Quinsac, population 1,866, is nestled in the heart of Bordeaux, only a few miles from famed winemaking centers such as Château Latour and Château d'Yquem, whose prized red and white wines fetch \$200 or more a bottle.

But even if September provides a bumper harvest, Quinsac's vinegrowers won't be celebrating. Almost all their grapes will be turned into low-end Bordeaux that sells for less than \$5 a bottle in France. Over the past three years, the price of many of their grapes has plummeted by 40%. In Quinsac, where Romans first planted vines and a poem inscribed on a fountain salutes "our wine that soothes the mind," vines are being pulled out to make way for a housing development.

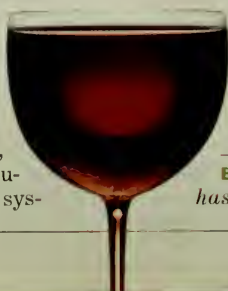
Sadly, Quinsac's bitter harvest is shared by much of France's wine country—from the hills of Burgundy to the valley of the Loire. France has dominated the world of wine for centuries and is still No. 1, with \$6.5 billion in sales. But the bouquet is fading. The almost medieval sys-

tem of small, family-owned vineyards is struggling to survive. Huge conglomerates from Australia, California, and elsewhere are outflanking the French. They're spending millions to create consistent brands recognized around the world, while Gallic vinegrowers are turning out too much low-quality table wine with mystifying labels.

Sure, swank restaurants in New York, London, and Tokyo still stock their cellars with the great French wines. But ordinary consumers don't have the patience to wait for fine Bordeaux wines to mature. They prefer the light, fruity flavors of low-price wine offered by producers in California, Australia, and Chile. These New World vintners are cleaning up in the markets that count: North America, Northern Europe, and Asia, where wine consumption is growing steadily, particularly of bottles under \$15, while the generic French wines from places such as Quinsac are losing sales. "We

are in the front lines in the fight against Australian and American wines," says Thierry Berthelot, commercial director of the Quinsac Wine Cooperative. Overall, French wine exports fell by 5.4% in value

BURGUNDY HARVEST: *Regional pride has become a liability*



PHOTOGRAPHS BY (BOTTOM LEFT) ARTHUR BECK/DOBBS STOCK MARKET; (RIGHT) OWEN FRANKENSTONE



last year, to \$4.6 billion, and millions of liters of unsold wine are sitting in cellars. France's market share in the U.S. has slipped from 7% to 5% in the past three years, while Australia has tripled its sales since 1995, grabbing almost 3% of the market, estimates Motto Kryla & Fisher LLP, a wine industry consulting firm in Napa Valley.

It's the latest chapter in France's ongoing and mostly losing struggle to balance its artisan traditions with the demands of the global market. Big distributors working with super-market chains want to have reliable wine producers supplying them. Brewers and liquor companies, with deep pockets and



Cover Story

published on July 31 by the French Agriculture Ministry.

Gallic tempers are rising as the bleak scenario unfolds. Angry winegrowers in the Mediterranean region of Languedoc ransacked highway tollbooths last March, demanding higher prices for their grapes. As wine revenues evaporate, southern France is on edge. A year ago, French cheese farmer Jose Bove won widespread popular support by

destroying a McDonald's outlet in protest against U.S. sanctions against Roquefort. This spring, French winemakers derailed an attempt by Mondavi to create a sprawling vineyard in the southern Languedoc region. "Each bottle of American and Australian wine that lands in Europe is a bottle targeted at the heart of our rich European culture," says grower Aimé Guibert (page 60).

GENERIC FLOOD? Some serious wine lovers—and not just French ones—sympathize. Jeffrey Davies, an American wine merchant based in Bordeaux who scouts out producers of small amounts of outstanding wine, worries that the globe will soon be flooded with generic Chardonnays and Cabernet Sauvignons. He yearns to preserve a world in which a Chardonnay produced in Chablis in northern Burgundy tastes drier than a rich, buttery



NAPA VALLEY HOSPITALITY: Deflating the stodgy and snobby wine world

marketing reach, are buying up winemakers. Within the past year, a series of takeovers and mergers has created new multinationals. Australia's beer baron, Melbourne-based Foster's Group, bought America's Napa Valley-based Beringer Blass Wine Estates last October for \$1.9 billion. In February, Australia's Southcorp, owner of the prestigious Penfolds and more budget-minded Lindemans brands, forked out \$725 million to take over family-owned premium winemaker Rosemount. "We've converted from being a cottage industry into a competitive consumer luxury-goods industry," says R. Michael Mondavi, chairman of Robert Mondavi Corp., the world's ninth-largest winemaker with more than \$500 million in annual sales (table).

During viticulture's Big Bang, France has stood sulking on the sidelines. Of the world's 10 largest wine companies, only one today is French. While three Australian companies dominate 80% of their home market, Bordeaux alone boasts 20,000 different producers. With the exception of isolated joint ventures such as Baron Philippe de Rothschild's with Mondavi in Chile and California, French wine companies remain provincial. Bordeaux growers find it difficult to cooperate even with Burgundy or Côte du Rhône producers. "We stick to our own

one produced less than 100 miles south in Burgundy's Côte d'Or. "We shouldn't lose these differences," Davies insists.

But surviving, much less thriving, will be difficult for France if they don't wake up to changes in drinking habits, even at home. Few natives still take three-hour lunch breaks, and fewer still down a *petit coup de rouge* at mealtime. The average French person today drinks just 14.5 gallons of wine a year, down from 26.5 gallons in 1960. At the same time, consumption has soared elsewhere, doubling in the U.S. and tripling in Britain. "To many young consumers, tasting cherry and blackberry in a Cabernet is a wonderful thing," as-

What Ails the French Wine Industry

TOO MUCH REGULATION

While New World growers are free to plant how they please, France sets strict limits on what types of grapes can be grown in a particular region and how they're planted and picked.

QUANTITY OVER QUALITY

Most French winemakers are paid for the amount of

grapes they deliver to a local cooperative, discouraging the careful pruning and limited yields needed to produce high-quality wine.

TOO MANY PLAYERS

The fragmented French wine industry is losing ground to overseas rivals who have created powerful global brands such as Rosemount and Beringer.

TOO CONFUSING

New World wineries make it easy for consumers to understand what they're buying by selling single grape varieties such as Chardonnay. Most French wines are labeled by region, making it difficult for consumers to distinguish between the wines of Burgundian villages

With Few Big Companies or Global Brands...

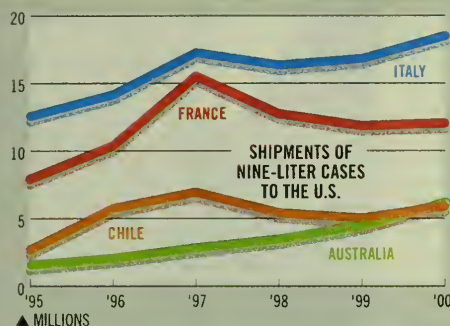
WORLD'S BIGGEST WINEMAKERS*

COMPANY	COUNTRY	WINE SALES IN 2000
1. E&J GALLO WINERY	U.S.	\$1.5 bil.
2. FOSTER'S GROUP	Australia	\$818 mil.
3. SEAGRAM	Canada	\$800 mil.
4. CONSTELLATION BRANDS	U.S.	\$712 mil.
5. SOUTHCORP	Australia	\$662 mil.
6. CASTEL FRERES	France	\$625 mil.
7. DIAGEO	Britain	\$590 mil.
8. HENKELL & SONLEIN	Germany	\$528 mil.
9. ROBERT MONDAVI	U.S.	\$506 mil.

*Excluding France's LVMH, which earns more than 75% of its \$1.6 billion in wine sales from champagne. Data: Direction des Etudes/Centre Français du Commerce Extérieur

Richard Sands, president, chairman, and CEO of Constellation Brands Inc. in

...France Is Losing Share in the U.S. Market



Data: The U.S. Wine Market: Impact Databank Review & Forecast, 2001 edition

airport, N.Y. His company has swelled to \$700 million a year in sales by recognizing that the palates of consumers who have grown up on soft drinks and Snapple may need coddling. Constellation's breakthrough product? Fruit-flavored wines, such as Chardonnay with peach flavors sold under the Arbor Mist label. While purists are appalled, the launch of the "pop varietal" in gently curved, frosty bottles has spawned a raft of competitors and has been credited by retailers with creating a new class of wine drinkers. Today, Arbor Mist and E. & J. Gallo Winery's Wild Vines sell 7 million cases a year, exceeding U.S. imports of midtier French wines.

Even in Britain, Bordeaux' earliest foreign market, the spread of wine drinking beyond the upper classes has meant a switch to American, Australian, and Chilean wines. France's exports to Britain plummeted 16% in value last year. "French wines can be very acidic, while the New World ones are rounder and easier to drink," says Fiona Hughes, a 35-year-old buying a bottle of Chilean Cabernet Sauvignon at Berry Bros. & Rudd wineshop in central London.

New World producers enjoy many advantages over France. Australian, American, and Chilean winemakers work in sunny, hot climates that produce regular harvests and consistent wines. Bordeaux and Burgundy producers must deal with unpredictable weather—resulting in variable vintages—and heavy-handed regulators who control the amount and type of vines they can plant. Strict regulations discourage innovation. Many New World wineries have begun adding oak

chips to wine that is fermenting in steel barrels. It's a cheaper way of imparting an oak taste without going to the expense of aging the wine in barrels. In France, that technique is illegal. Irrigation, too, is banned in most of France. "It's like playing rugby when the Australians can pass the ball forward and we can only pass it backwards," complains Jean-Marie Chadronnier, CEO of one of France's largest wine producers, CVBG Compagnie des Vins de Bordeaux et de La Gironde.

When it comes to marketing, the playing field is even more unequal. In Britain, Bordeaux merchant Chadronnier says his \$150 million-a-year company can afford only two salesmen. Southcorp, with \$540 million in sales, employs 50. Gallo, the world's largest wine company, spent more than twice as much last year on advertising and promotion in Britain as the entire Bordeaux wine industry, according to the recent French government report. Rather than cooperate, the French often fight among themselves for shelf space. "The people in Bordeaux see Burgundy as the competition," says Victor Motto, partner at Motto Kryla & Fisher. "The people in California see the world as competition."

KUNG FU CACHE. The New Worlders are succeeding by injecting pizzazz into the stodgy, snobby wine industry. American vintners have vied with one another to open the most lavish hospitality centers, complete with everything from visiting chefs to aerial trams and art collections. This year, Mondavi opened a "demonstration vineyard" in Walt Disney Co.'s new California Adventure theme park that features not just the vineyard but a movie theater and three tasting rooms. Most French châteaux don't accept visitors without an appointment—and even then, all that most have to show is a musty cellar.

The Australians are using star power to attract new wine tasters. Kung fu star Jackie Chan has flogged Lindemans in Asia, and Australian golfer Greg Norman has teamed up with Foster's Beringer to sell Greg Norman Estates wines. In the year and a half since it was launched, the Norman line has become the 10th most-popular Australian brand in the U.S. and sold a respectable 170,000 cases worldwide last year. "It

MARKETING

French winemakers afford to keep up with world competitors on advertising and other promotion. In England, E. & J. Gallo's marketing budget last year reached \$2.5 million, more than twice what the Bordeaux region spent on marketing.

Data: BusinessWeek



IN SOUTHERN FRANCE: Non-EU wine gets the ax



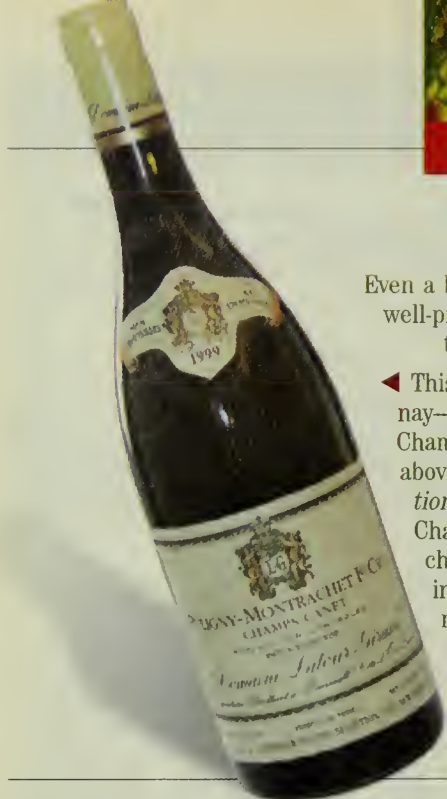
Cover Story

Tale of Two Labels

Even a beer bum can understand that this popular, well-priced Australian white wine (\$10) features the Chardonnay white wine grape. ►

◄ This French wine (\$50) also is 100% Chardonnay—but only a connoisseur would know that Champs Cavet is a small piece of land located above a Burgundy village where local *appellation contrôlée* rules permit cultivating only Chardonnay. Even then, it would be best to check out Domaine LaTour in a wine rating book, since dozens of producers and merchants sell expensive Puligny-Montrachets that range in taste from the sublime to the substandard.

Data: BusinessWeek



makes a mockery of all the history and the heritage and the 100-year-old vineyards and wonderful châteaux,” says Beringer Blass Managing Director Terry Davis.

The Australians and Americans are demystifying wine in other ways, too. Compared with French labels, some of the best-selling Aussie brands—Wolf Blass, Penfolds, and Rosemount—are easy to read and remember. What’s more, Australian labels tell you exactly what grapes you’re getting—a Merlot, Cabernet Sauvignon, or a Chardonnay.

In contrast, the French system of labeling by geographic origin rather than type of grape results in widespread confusion. There are 450 different AOC (appellation d’origine contrôlée, or registered origin names). Connoisseurs study for years learning to distinguish between the wines of Burgundy villages such as Vosne-Romanée and Gevry Chambertin, each of which boasts dozens of growers, many bottling their own wines of vastly different quality. “Everyone agrees that we

have to simplify the offer,” says Allan Sichel, president of Bordeaux merchant house Maison Sichel.

But vested interests resist change. Bordeaux classifications of top-ranking châteaux were made in 1855, and only a single alteration, adding Château Mouton Rothschild to the elite club in 1973, has been made since. “About 500 wines have a classification, and they rake in money while the rest, no matter how good, struggle,” says Daniel Cathiard, owner of Château Smith Haut-Lafitte, which was left off the 1855 listing. Generic Bordeaux wines from places such as Quinquevins don’t have a classification and have no chance of achieving elite status.

The global wine gang can produce large quantities using single grape varieties grown almost anywhere and sold under recognizable brands such as Rosemount’s Shiraz and Linea’s Bin 65 Chardonnay. And they can ensure consistency by blending grapes from different regions. A hailstorm in Monterey? Mondavi can ship in grapes from fields around ne-



‘WE ARE BOTTLING HISTORY

Elegant, white-columned Chateau Margaux stands proudly at the end of a grand, tree-lined driveway. Inside, visitors are welcomed to reception rooms decorated in Napoleon III Empire style. Below ground, they visit cellars shimmering with new oak barrels. “We are bottling history,” says Paul Pontellier, the chateau’s chief winemaker.

And history sells. While France

GRAPES OF WEALTH: Château Margaux and the other elites are riding high

y Santa Barbara. Even
s the economy weakens,
he new wine giants use
heir financial strength to
in market share from
oorly capitalized French
ompetition. Mondavi in-
reased its marketing
udget by 40% this year.
When there is a concern
a the economy, people
re afraid to buy Châ-
eau No Name and they
ome back to the names
nd the brands they can
rust," says R. Michael
ondavi. California wine-
makers such as Gallo are
ven pushing its wines in
France.

Large marketing bud-
gets are crucial, particu-
larly as most wine no
onger is bought in spe-
cialty liquor shops. Su-
permarkets sold almost half of the wine in America last year,
p from a quarter in 1987. In Britain, big retailers such as
tesco, Sainsbury, and ASDA sell more than 70% of all wine—
nd their buyers favor suppliers who can provide large vol-
umes, something the French cannot. "When you get to the
ore esoteric French lines, they are not so accessible to the
verage drinker," says Nicki Clowes, a Tesco wine buyer.

RY VS. "LUSCIOUS." Marketing types are working to take
ne guesswork out of wine buying. New York's Best Cellars
nc. organizes about 100 carefully selected \$15-and-under
ntries not by country of origin or style but rather in eight
roupings with names like "fizzy," "soft," "luscious," and
oig." The concept has helped it expand into Boston, Seattle,
nd Washington.

Will the French have to resort to such gimmicks to stay in
e game? Maybe not. If they can create a range of offerings at
ifferent prices around their world-renowned labels such as
hâteau Margaux and Château Cheval Blanc, the elite
hâteaux could become like the couture houses, expanding
heir brand to lower-priced but quality vintages. The Aus-
tralians are already moving that way. A new drinker can
art out with an \$11 Penfolds Koonunga Hill, say, and work up
o Grange, which goes for \$180 a bottle. Southcorp CEO Keith



EN GARDE: This Tokyo wine bar sells only Australian vintages

More defections may be coming. Some French are disre-
garding AOC rules and labeling their bottles as table wines.
This allows them to plant the grapes they think will produce
the best product. Grower Dominique Becot deemphasizes
Saint Emilion, putting the locale in small letters on his label,
but his critically acclaimed La Gomerie still sells for over
\$100 a bottle. Even in marketing, the French are waking up.
The Bordeaux Wine Board has doubled its ad budget in
Britain in the past two years. A new campaign features a
sexy model dressed in red velvet lingerie hovering over a
muscular man. "Let the mood take you to Bordeaux," reads
the caption.

But advertising alone won't do the trick. Thousands of
acres of inferior vines must be ripped up. Hundreds of the
872 French cooperatives must merge or shut down. Bor-
deaux merchant houses must start cutting deals not only
with their Burgundian brothers but with New World partners.

Ground zero is the hot southern swath of the country called
Languedoc-Roussillon. It produces 9% of the world's grapes and
a third of France's total. Massive overproduction of poor wine
has been subsidized for years. For a long time, the European
Union bought up the region's unsold wine and distilled it into
industrial alcohol. Even though farmers were paid to tear up

market wines struggle, prices for
00 harvest of the seven elite Bor-
châteaux, including Château Mar-
more than doubled this year,
ing as high as \$250 a bottle. That's
he wholesale price. The wine itself
in the cellars and must age two
in barrels. By the time it's dis-
d to stores in 2002, consumers
be paying as much as \$1,000.
it's behind the frenzy? Admittedly,
is high. After trashing the
re 1999 vintage, influential U.S.
ritic Robert M. Parker awarded
ades to the 2000 Bordeaux in his
Advocate newsletter and on CBS's
wines. And there's the millennium
"It's the three zeros," says Flo-
Cathiard, co-owner of Château
Haut-Lafitte.

Prices of elite Bordeaux have been
rising fast in the past two decades as
Americans and Asians developed a taste
for the high life. Limited supply also
helps prop up the price. Margaux and

the other elite châteaux produce only
750,000 bottles a year—a drop in the
ocean of the 700 million bottles of Bor-
deaux produced annually.

Still, a further downturn in the global
economy could cool the palates of these
nouveau riches buyers. And the eye-
brow-twitching prices could mean that
people are buying top wines as invest-
ments to be sold later at auction rather
than to be sipped. On Sept. 14, the Eu-
ronext exchange in Paris will begin sell-
ing futures for the top Bordeaux. "We
are running the risk of speculation," ad-
mits Pierre Lurton, Chateau Cheval
Blanc's managing director. Bordeaux had
better hope its millennial bonanza doesn't
end up producing a nasty hangover.

By William Echikson
in Margaux, France

Top of the Top End

CHATEAU CHEVAL BLANC	\$250
CHATEAU LATOUR	\$225
CHATEAU MARGAUX	\$225
CHATEAU HAUT-BRION	\$225
CHATEAU LAFITE-ROTHSCHILD	\$225
CHATEAU AUSONE	\$190
CHATEAU MOUTON ROTHSCCHILD	\$180

*Wholesale prices per bottle for the first growth
2000 Bordeaux Data: *BusinessWeek*

their vines, the flood continues, and an even more painful shakeout looms. Hundreds of millions of liters of unsold Languedoc wine already are stored in cooperative cellars. This year's harvest could triple that amount. "I just don't know how we are going to sell it," admits Jacques Bonnier, director of the cooperative in the village of Aniane.

Both the EU and the French government will come under pressure to fork over handouts to struggling vintners and to push for quotas on New World imports. That would surely be a mistake. New competition certainly will force French wine-



makers to improve, and even some of the wine Establishment welcome such change. "When I see Gallo trying to sell wine in Paris, I celebrate because it's the only way to wake us up from our slumber," says Philippe Capdou-

president of the Bordeaux wine merchant house FICOFI. And a better bottle of Bordeaux, even if it's picked off a supermarket shelf, would be something just about everybody could celebrate.

By William Echikson in Bordeaux, with Frederik Elvén in Sydney, Kerry Capell in London, Linda Himelstein in San Mateo, and Gerry Khermouch in New York

HOW MONDAVI'S FRENCH VENTURE WENT SOUR

David Pearson loves wine and France. The San Diego native studied oenology at the University of California and spent a year after graduation working as an intern on French wine estates. So when Robert Mondavi Corp. asked him in 1998 to head up its Vichon Mediterranean subsidiary, the fresh-faced, French-speaking, 39-year-old Pearson crossed the Atlantic and settled in Southern France. In a hard-pressed region best known for producing oceans of cheap wine, he was confident that New World money and technology could produce superb bottles selling for \$60 or more.

But this August, the energetic American packed up his belongings and returned to California. An unlikely coalition of local farmers, ecologists, hunters, and communists had painted him as a capitalist plotter and succeeded in killing his ambitious \$7.5 million plan to acquire 120 acres of prime grape-growing land on an untamed Mediterranean hillside. "I felt like the Cuban boy Elián González, who became a symbol, in a weird, deformed way, of the clash between two worlds," Pearson laments.

Pearson spent his first two years conducting geological surveys to locate top-quality wine real estate. He needed a large tract to produce 260,000 bottles a year, the minimum number that made economic sense for a giant such as Mondavi. He finally settled on a swath of hillside above the 2,000-person village of Aniane, about 15 miles northwest of the regional center of Montpellier. "We saw David and Mondavi as the people who could help



PEARSON: "We've decided it is too difficult to make wine in France"

us survive the crisis," says Jacques Bonnier, director of the local wine-growers' co-op. In July, 2000, Aniane's town council voted to give Mondavi a 99-year lease.

A violent backlash ensued. Hunters worried that planting vineyards would frighten away wild boar. Environmentalists railed against razing a forest. Pearson sipped pastis with the locals, reassuring them that the company intended to plant small "islands" of vines and leave much of the natural scrubland untouched. Hunters, he promised, still could roam the hillside during autumn.

But the American couldn't shake off one far-reaching charge—that the invading Anglo-Saxons would destroy the village's social cohesion and deform traditional winemaking methods, imposing an alien, money-grubbing industrial model. Leading this crusade was Aimé Guibert, a former businessman whose glove factory had been driven

into bankruptcy by Asian competition and whose Mas de Daumas Gassac vineyard produces an internationally renowned red. The 76-year-old Guibert eschews pesticides, harvests his grapes by hand, and traces the origins of his vines back to Palestine at the time of Jesus Christ. "The Mondavis will end up destroying our traditional artisans who make wine, just like McDonald's is destroying French gastronomy," Guibert thunders.

"NO POINT." In March municipal elections, Aniane's voters threw out the town council and elected as mayor an anti-Mondavi communist, Manuel Diaz. Diaz de-

nounced Mondavi as a menacing multinational similar to Marks & Spencer, which was throwing thousands of French workers out of jobs in order to invest more in its British stores.

"When we heard what he was saying, we knew there was no point in staying," Pearson says. In May, Mondavi canceled the vineyard project and is preparing to sell its Vichon brand.

Back in Aniane, winegrowers are suffering. Almost 15% of last year's harvest remains unsold. Mayors of 30 other French villages have written Mondavi seeking investment. But it's too late. "For now, we've decided it is too difficult to make wine in France," Pearson says. In September, he becomes managing director of another Mondavi wine near Santa Barbara. The francophile American says he'll miss Southern French cooking—but the wine certainly has left a bad taste in his mouth.

By William Echikson in Aniane, France



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In early 1993, at a team-building exercise at the posh Claremont Hotel in Berkeley, Calif., executives from software maker Cadence Design Systems Inc. were asked to draw an image that described themselves. While many people pondered what to draw, division president Gerry Hsu—a talented artist, according to two attendees—quickly dashed off a picture of a big, powerful bird flying off into the distance, droppings falling all the way. “I always know where I’m going, and I get there very fast,” he explained at the time, “but I tend to leave a trail of s--- behind me.”

Who could have predicted he would leave behind this much of it? Since departing Cadence for Avant! Corp. (pronounced Avanti) in 1994, Hsu has transformed the tiny software boutique from a \$2 million-a-year startup into a roaring profit machine that earned \$70.9 million on sales of \$358 million in 2000. But now the hard-driving Taiwan native, who used to have an apartment next to his office so he could work around the clock, has helped to create a mess of historic proportions. On May 22, Hsu and five top managers pleaded no contest to charges that they conspired to steal Cadence software. He’s been fined \$2.7 million, and four other top Avant! executives are headed to jail. Meanwhile, the company has been struggling to come up with enough cash to pay \$230 million in additional criminal penalties. It is also facing a potentially crippling civil suit by Cadence. From May 21 to Aug. 22, the share price has tumbled from \$18.55 to \$7.55.

CRIMINAL ORIGINS. The Avant! case is probably the most dramatic tale of white-collar crime in the history of Silicon Valley. Hsu & Co. parlayed a product containing purloined code into a thriving 1,500-employee public company, with a gleaming, modern office complex in Fremont, Calif., and a highly visible charitable foundation that has blanketed the Bay Area with radio ads. “What makes the case unique is that you have a large, publicly traded company that was founded and built on stolen property,” says Santa Clara

DOES CRIME PAY?

The inside story
of Avant!, a
company that
stole software code



County Deputy District Attorney Julius Finkelstein, the onetime computer-science graduate student who prosecuted the case (page 66).

That’s bad enough. But in a month-long investigation, *BusinessWeek* has learned that the problems at Avant! go beyond the issues raised in the criminal case. Hsu has been running

the company almost as if it were his family business—seemingly without regard for many common tenets of corporate governance, according to more than a dozen former co-workers and customers. He pays CEO-level salaries to his son and a former flight attendant, though former employees say both have limited business backgrounds.

A CASE OF PURLOINED PROGRAMMING

FEBRUARY '91

Stephen Wu and three others leave Cadence to start ArcSys, the predecessor to Avant! Wu departs with a tape drive containing 30,000 lines of the Cadence’s database code, say prosecutors.

MARCH '93

Avant! begins selling “place-and-route” software using the Cadence code.

MARCH '94

Gerry Hsu bails out of Cadence to join Avant!

MAY '95

Avant! raises \$31 million in IPO.

DECEMBER '95

In a raid of Avant! on Dec. 5, the DA finds 40 gigabytes of computer files containing Cadence code.

1991

1992

1993

1994

1995



STILL DEALING
Gerry Hsu didn't
just avoid a
jail term. He
got a raise.

question was unimportant and that the company made every effort to remove stolen code. As for questions of improper

governance, Avant! executives say employees are paid appropriately, that all the deals with companies owned by Hsu have been negotiated at arm's length, and that the primary reason for Avant!'s success is its innovative engineering—a point echoed by others in the industry. "Avant! is a leading company with very strong products," says Bernd U. Braune, CEO of Get2chip Inc., a rival design software company. "Some individuals made some mistakes, and they are going to have to pay. But if someone says they were only successful because they stole some code, I think that's definitely wrong."

Avant! is also making an effort to clean up its image. On July 25, the

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company announced that Hsu would pass day-to-day control to former Chief Operating Officer Paul Lo, who would replace Hsu as president. Lo's first move: to issue a public apology. "Avant! Corp. is sorry for the events of the past," he wrote in a public letter. "We pledge to work hard to deserve the trust and support of our industry."

But few outside the company believe there has been any real change—and they point to Hsu as the main reason. Although he pled no contest to securities fraud, conspiracy to steal trade secrets, and failure to return stolen property, Hsu is managing to avoid jail time, largely because there was no evidence that he directly participated in the thefts, according to Finkelstein. By contrast, co-conspirators Mitch Igusa, Eric Cheng, and Stephen Wu were caught with Cadence code.

To alleviate the sting of the criminal proceeding, the board is paying Hsu's entire fine as well as all of his legal

rounds. Under Hsu's watch, Avant! has also invested or made business deals with at least four other companies in which he has personal stakes. Meanwhile, Avant! dismissed KPMG International as its auditor last year. In a legally required filing to the SEC, the auditor outlined a wide variety of concerns about the software company's

accounting practices. "To Gerry, every system is made to be manipulated. You push the line as far as it can go—hopefully without breaking it," says one associate.

Hsu, 56, declined repeated requests for interviews and did not respond to written questions. But in court, his lawyers have said that the software in

'97
 ct Attorney Julius Finkelstein brings
 nal charges against Avant!, Hsu, and
 associates. He charges the company with
 separate acts of theft.

MARCH '00

With its acquisition of Analogy Inc.,
 Avant! ends a 13-company, \$230
 million acquisition spree that has
 expanded its product line beyond
 the software that included
 purloined code.

JULY '01

Avant! is ordered to pay \$230 million in
 criminal penalties, and four former execu-
 tives go to jail. The stock price plummets,
 but Hsu escapes jail time and the company
 pays his fine.

1997

1998

1999

2000

2001

Using a variety of tactics, Avant!'s legal team managed to get three judges in a row to leave the case

expenses. More important, he is remaining as the chairman of Avant!'s board and its chief strategist—roughly akin to William H. Gates III's title and role at Microsoft Corp. Despite all the rogue behavior, fellow board members seem untroubled by Hsu's record.

Legal Affairs

INVESTIGATIVE REPORT

When the company announced his new role, it cited a mild heart attack as the reason, with no mention of the Cadence case. According to board member Daniel Taylor, a retired U.S. Forest Service park ranger, directors never considered asking Hsu to leave. "He's too precious," Taylor says.

In fact, the board will increase Hsu's \$1.6 million salary by 5% a year through 2008, according to documents filed on July 25. That's five times more than Lo's \$310,000 annual pay. The board is even trying to cement a continued role for Hsu with a new "poison pill." According to new employment contracts also unveiled on July 25, any decision by shareholders not to reelect Hsu as chairman would be deemed a "change in control." That, in turn, would allow many managers to cash out their options, thereby raising the cost of any hostile attempt to oust Hsu.

"NO.1 QUESTION." All of this conduct raises red flags with corporate governance experts. Despite conduct that would be completely unacceptable at most public companies, Hsu has skated through the Cadence debacle without any meaningful punishment. And though the stock has plummeted, most analysts believe Avant! will ultimately survive. "The No.1 question is why they didn't fire the guy," says Nell Minow of the Corporate Library, a shareholder rights Web site. "There's something really, really wrong here."

In truth, there has been something wrong at Avant! from the beginning.

The company started in classic Silicon Valley form when four Cadence engineers struck out on their own in 1991. But one of them, Wu, also took a computer tape containing 30,000 lines of Cadence database code that would show up in the fledgling company's first product, prosecutors say. The database isn't the primary reason customers would buy one of these "place-and-route" programs, which are used by chip designers to stuff millions of circuits onto tiny bits of silicon. But, like a transmission in a car, it's a necessity. Combining this transmission with its own superior technology, the startup, which then went by the name ArcSys, quickly won over big customers, such as Intel Corp. and Motorola Inc.

To build on that early success, ArcSys' founders lured

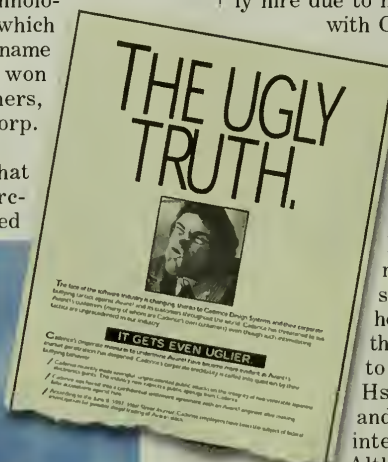
proach to place-and-route software. While ArcSys software let engineers lay out chips circuit by circuit, competitors were introducing "area-based" programs that allowed entire sections of chip design to be automated. Finkelstein quickly tried to buy a startup with such technology.

When that failed, the company soon took another tack. It acquired two batches of Cadence software code from former Cadence employees Mitch Igusa and Eric Cheng. Hsu's role? Finkelstein says he set up a slush fund to pay Igusa, who Avant! couldn't directly hire due to his noncompete contract with Cadence. Igusa, who set up shop with

Avant! vice-president across the street from the company offices, received checks totaling more than \$20,000 over the next few months. When Finkelstein says he has no evidence that Hsu stole anything himself, he says that Hsu was "in the center" of the scheme to pay Igusa. In court, Hsu denied this accusation and said the money was intended for investment. Although Hsu pleaded no contest to two charges that are ordinarily felonies—trade-secrets theft and failure to return stolen property—Finkelstein dropped the charges to misdemeanors after Hsu paid his fine.

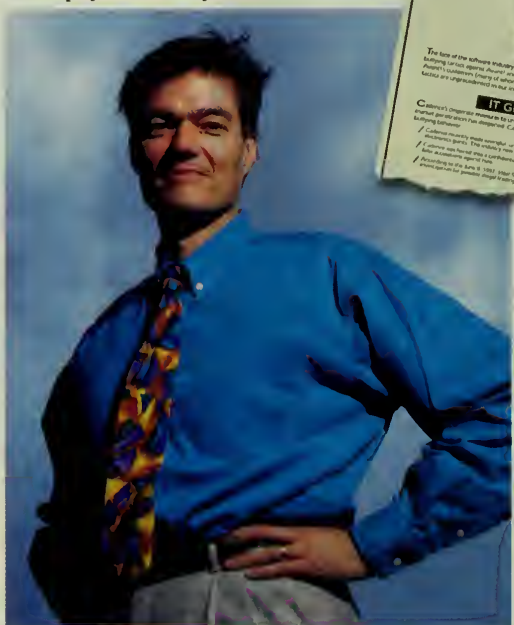
Cadence might never have discovered the theft had not a former programmer noticed a slight flaw in the Avant! software—that he had created years before while working for Cadence. He tipped off

former Cadence CEO Joe Costello, whose lawyers later contacted prosecutor Finkelstein. That led to two raids in 1994 and 1995, which turned up stolen code at Igusa's home and in Avant! headquarters. Although the evidence was damning, Hsu responded by declaring war on his former employer. "He'd say: 'I'm going to fight this to the death. They don't know what they're dealing with,'" recalls one former executive.



FIGHTING DIRTY

When former Cadence CEO Joe Costello called in a prosecutor, Avant! ran this ad accusing him of using the courts to hurt a rival



Hsu to join as CEO in March, 1994. A self-made success, Hsu often bragged that his first job upon arriving in the U.S. had been cleaning toilets. "Gerry's charisma [is] intensity-based," says one longtime colleague. "He doesn't tire. He's like an infinite source of energy. It's inspiring."

Soon after arriving at Avant!, Hsu discovered that the company wasn't keeping up with its rivals, which had developed a more sophisticated ap-

Fight he did. On the legal front, Hsu assembled a defense dream team that included many of the Bay Area's top criminal lawyers. The attorneys ran a scorched-earth campaign. Using a variety of tactics, the attorneys managed to get three judges in a row to leave the case. They also made three unsuccessful attempts to disqualify prosecutor Finkelstein. "The defense left no legal stone unturned," says Finkelstein.

Hsu also worked the public-relations angle. After Finkelstein brought criminal charges in April, 1997, Hsu launched an advertising campaign to turn public opinion. Avant! hired media consultant Mark Fabiani, who had helped the Clinton Administration through the Whitewater scandal. That October, the company ran a full-page newspaper ad headed "The Ugly Truth," with a grotesquely morphed photo of Costello, claiming Cadence was using the courts to hurt a nimble competitor.

Then, in 1998, Hsu set up the Avant! Foundation, which has bombarded Silicon Valley residents with syrupy radio ads offering to give away everything from college scholarships to free cars for the elderly. According to state records, the Avant! Foundation spent most \$1.4 million promoting itself in 1999 and 2000—nearly twice what it is given away. Matt Lipschultz, the foundation's director of operations, says the promotions were necessary to find candidates for funding and that it now ends "more on programming."

EXPERIENCE. By then, Avant! had successfully bought itself a lot of time. Based on Hsu's assurances that the charges against him were bogus, investors ponied up \$31 million in a June, 1995, initial public offering. Profits soared, and the share price zoomed from \$3 to \$45 by late July. Hsu cashed in on the company's success by embarking on a 13-company, \$230 million acquisition spree, enabling Avant! to take on rivals Cadence and Synopsys Inc.

Even as a public company, though, Avant! was run almost like a sole proprietorship. According to several pre-



HEADQUARTERS

Avant!'s public image is a high priority for Hsu

repeated requests for comment.

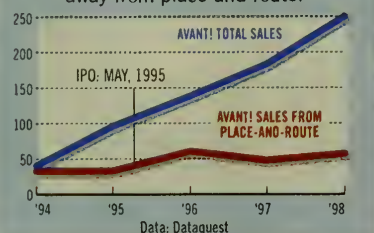
The second-highest-paid executive at the company is Noriko Ando, who earned \$1.46 million in salary and bonuses in 2000. Previously a Japan Airlines flight attendant, Hsu hired her when he was at Cadence to help him arrange travel in Asia and

coordinate meetings with executives from big Japanese customers, say several Cadence sources. Fiercely loyal to Hsu, she quickly rose through the ranks to become head of operations. "She's good at doing what Gerry tells her to do," says a former Avant! executive, who adds that Ando's salary and power have become a source of bitter controversy within the company. "She doesn't know anything about technology," says another source. Ando declined to comment on her salary or qualifications. Since Lo became president, Ando and John Hsu have been moved to new positions, but there has been no change in their compensation, says a company spokesman.

So far, the board of directors has let Hsu get away with such actions. Of the six members other than Hsu, five have connections to Avant! insiders. Former park ranger Taylor is a friend of Hsu's sister. Also on the board are a venture capitalist in whose fund Avant! has invested \$10 million, a former Avant! customer who now runs one of its distributors, and a former Avant! manager. The board has always been generous with Hsu. Thanks to a \$2.8 million bonus in 2000, Hsu made twice as much as the CEOs of rivals Synopsys and Mentor Graphics Corp., although

TAINTED BIRTH

Avant!'s early success was based largely on the sale of place-and-route software. Cadence claims that much of Avant!'s growth in its market was attributable to stolen code, which Avant! strenuously denies. Over time, Avant! has diversified away from place-and-route.



sent and former employees, many family members have always been on the payroll. Hsu's son, John H. Hsu, is head of Avant!'s Asia operation, though he only received his master's degree in marketing from Loyola Marymount University in 1998. According to company documents, John was 27 as of July 27, and earned \$209,996 in salary and a \$778,629 bonus in 2000. "He's a nice kid, but he's extremely inexperienced," says one former executive. "He's a good softball player," says another. John Hsu did not respond to

OVER THE LINE?

Apart from legal problems, Avant! Chairman Gerry Hsu has drawn criticism for a variety of business practices

BOARD OF DIRECTORS Most board members have close ties to Avant! and Hsu. Some have suspect qualifications, including a former park ranger who is friendly with Hsu's sister.

ACCOUNTING In a letter to the SEC, former auditor listed such concerns as "incomplete and missing

contract documentation" and "inadequate internal communications in connection with recording revenue."

COMPENSATION Hsu pays an enormous salary to 27-year-old son John, who earned nearly \$1 million despite his lack of experience. The company's second-highest-paid employee is a former stewardess Hsu

met years ago, who took home nearly \$1.5 million last year.

PUBLIC RELATIONS After being hit with criminal charges, Avant! set up a foundation that offers grants to Silicon Valley residents. Trouble is, it has spent nearly twice as much on promoting itself via radio ads as it has on good works.

One of the most troubling aspects of Avant! is its history of making deals with companies partially owned by Hsu

both of those companies are bigger than Avant!, and their stocks have performed much better. The company's general counsel, Clayton Parker, says, "Avant! is far and away the most profitable company in the [electronic design] industry. Perhaps it should be no

Legal Affairs

INVESTIGATIVE REPORT

surprise that the CEO is well compensated for that."

Hsu may get along well with the board, but he has had a harder time with outside auditors. In 2000, Avant! dismissed KPMG as its outside auditor. Not long afterward, the auditor filed a legally required document with the Securities & Exchange Commission in which it expressed concerns about fiscal years 1999 and 2000, including "incomplete and missing contract documentation," "inadequate internal communications in connection with recording

revenue," and "lack of timely and accurate account reconciliations in a number of areas, including cash, unbilled accounts receivable, prepaid commissions, and investments in affiliates." KPMG won't comment further. While not necessarily an indication of fraud, says David F. Larcker, an accounting professor at the Wharton School, such a long list of grievances is unusual and indicates that KPMG may have believed its auditors were not getting sufficient information from the company. Avant! Finance Chief Viraj J. Patel denies any impropriety. "We're not cooking the books."

Critics say Hsu's history with the board—and the KPMG incident—are troubling, given Avant!'s history of making deals with other companies that Hsu has invested in. In 1997, for example, he, Ando, and a few others created a new Japan-based company called Maingate Electronics to distribute Avant! software. Hsu personally owns 50% of Maingate, with the rest held

by Ando and an investment fund, which other Avant! insiders are investors.

The Maingate deal is legal, to sure. But it does create an opportunity for abuse. For example, Avant! has refused to disclose what price Hsu and other insiders paid for shares of Maingate recently bought back from Avant!. That raises a question of whether Hsu, with the support of the board, granted himself a low purchase price. And given Hsu's big stake in Maingate, it could be in his interest to pay Maingate overly cushy commissions—a potential means of shifting profits from Avant! shareholders to Maingate's owners. "The CEO should never be investing alongside the company," says Corporate Library's Minow. "That's just terrible. The temptation is too great to have the company prop up your investment."

Apparently, Maingate isn't an anomaly. When Avant! decided in 2000 to spin off its Taiwan operation into a new entity called Avant! Hi Tech

WHITE-COLLAR PIT BULL

Julius Finkelstein is a rare bird. He not only boasts a graduate degree in computer science from Stanford University but also a law degree from Duke University. That makes him the perfect person to run the high-tech-crimes unit at the district attorney's office in Santa Clara County, Calif.—where he reigns as the top white-collar crime cop in Silicon Valley.

As Avant! Corp. learned the hard way, the 54-year-old Finkelstein is a tough opponent. Working with two associates, he took on 10 high-powered law firms that billed the company more than \$30 million in fees. Using nearly every stonewalling trick in the book, his adversaries nearly got the case thrown out on a technicality last March, when a grand jury indictment that had required three months and 50 witnesses to secure was rejected. The reason: The court recorder had transcribed the actual testimony but not the courtroom banter during the rest of the proceedings.

Finkelstein also took some heat for his handling of the case. Many in Silicon Valley felt the case was a mere business dispute that should have been

left to the civil courts. Others felt Finkelstein was too close to Cadence. Some defense lawyers, for instance, argued that it was inappropriate for him to use expert testimony paid for by



THE PROSECUTOR

Finkelstein prevailed despite the efforts of 10 high-powered law firms that billed Avant! about \$30 million in fees

Cadence in a separate civil suit. They also complained about the fact that some Cadence insiders, tipped off to a raid of Avant! offices in 1995, shorted Avant! shares. Finkelstein points out

that his use of Cadence-funded experts was upheld by the Court, and denies he inappropriately tipped off Cadence about the raid.

His victory has washed away much of the criticism. He may even alter Silicon Valley's fast-and-loose approach to intellectual property theft. Until now, when an employee is caught walking off with purloined code, it is quietly settled with a check and an apology. Finkelstein says that's not good enough given how central it is to the New Economy. "Companies that use stolen technology are like gold mines that don't actually own any gold," he says. In the wake of the Avant! case, execs who use stolen code now even face jail time.

By Peter Burrows

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Inc., Hsu ended up with an 5% share and his son John got 3%—making John the second-largest owner. Avant! would not say what price per share the Hsus paid for their stakes. And in 2000, Hsu invested \$1 million of his own money in SMIC, a China-based startup that will build semiconductors on a contract basis. Later that year, Avant! committed \$100 million. Since that corporate investment came in a later round of financing, the company could have paid a higher price per share. The company declined to provide detailed information on Maingate, Avant! Hi Tech, or SMIC.

All the unusual activity at Avant! has not gone unnoticed by shareholders. On Oct. 5, 1999, a former Avant! executive and shareholder, Roy Jewell, wrote to Hsu and the board members demanding a range of reforms. The letter asked that Hsu reconstitute the board so that half the members be independent, put all employees involved in the criminal case on leaves of absence, establish formal executive compensation and succession plans, and implement a variety of moves to give investors better information about Avant!'s overseas holdings and financial performance to Wall St. He briefly considered a proxy fight to force Hsu to shake up Avant!'s board, but concluded his odds of success were low and the cost would be high. Many "shareholders were getting pretty frustrated with their inability to influence Gerry or the board," says Raj Seth, a software analyst at SG Cowen Securities Corp.

Will that frustration boil over again? Maybe. Avant! still faces a civil suit filed by Cadence, which will probably seek damages of more than \$1 billion but is likely to take at least another year before it's resolved. Some customers, worried about Avant!'s financial picture and angered by Hsu's prior insistence on his innocence, say they may look to newer design software companies with hotter technology. The biggest concern: that many of the top-notch engineers who believed Hsu's claims may now leave Avant! to escape the legal cloud.

But few people are willing to count Hsu out entirely. He's nothing if not a survivor. "Gerry's favorite book has always been Sun Tzu's *The Art of War*," says his old nemesis, former Cadence CEO Costello. "Well, the general is a little bit down and has lost a few battles. But he's still alive." No doubt. But if history is any guide, Hsu will simply regroup and prepare for the next fight.

By Peter Burrows in San Mateo, Calif.

Finance

MARKETS

HOW TO READ THE INSIDERS' STORY

A quick glance suggests they are bearish, but closer analysis shows confidence in the markets' future

The conventional measures of corporate insiders' confidence in the stock market are awfully discouraging. In the past two months, executives and directors sold shares in their companies more than three times as often as they bought. Another ratio of selling to buying is even uglier: Insiders sold \$19 of stock for every \$1 they bought. Their actions seem to forecast no end to bear-market pain.

But take heart. Insiders are actually turning away from their punishingly bearish conduct of the past two years. The key is insider selling volume by itself, without comparison to buying statistics. The increasing use of stock options for executive compensation has distorted the insider buying numbers. When insiders use options to acquire their company shares, those transactions are not included in the buy data.

Sell volume has fallen dramatically this year, easing pressure on the market. Average monthly insider selling over the past six months was \$3.3 billion, vs. the \$5.9 billion rate in early 2000, when the market was at its high, according to Thomson Financial/Lancer Analytics. Also, the number of insider sell orders is down 45% in the past two months, compared with February and March, 2000.

If the trend holds, it will clearly benefit stocks, helping the market at least to hold current levels. The decline in selling carries an important message for investors: Even though business has slowed, fewer people who are in the know think their stocks are too high.

When insiders dump shares, stockholders can't help but worry that they are missing some signs of coming trouble, says Eric Bjorgen, analyst at Leuthold/Weeden Research. Bjorgen counting only big block transactions involving at least \$1 million of stock, 100,000 shares, says the dollar value of net insider selling in the past 10 weeks is 0.8% of the value of the market, down from a peak of 1.8% in May, 2000. "I'm sure like what I see so far," he says.

Another measure, registrations for public sale of restricted stock, which includes shares held by venture capital

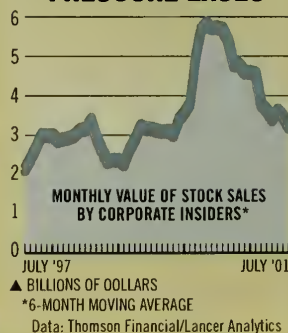
ists, is down to its monthly average of \$7.4 billion, from \$16 billion a year ago. "That's a big decrease in the supply of restricted stock," says Paul Elliott of Thomson Financial/First Call.

For decades, analysts have tried to divine the direction of the stock market by examining insider trades. "Insiders certainly know more about a company than any analyst," says David Coleman,

editor of *Vickers Weekly Insider Report*. Investors want to know what insiders do, not just what they say.

Traditionally, analysts gauge insider sentiment by watching ratios of selling to buying, whether comparing numbers of transactions, numbers of shares, or dollar values. Tracking buys has been

SELLING PRESSURE EASES



As more insiders use options to acquire



considered critical. After all, insiders may have personal reasons to sell, but they only buy big blocks of stock if confident about the outlook.

Sell-buy ratios have been worthy indicators of past market moves. A ratio calculated by *Vickers* showed a big shift in insider selling in late 1986, before the 1987 market plunge, and then a shift toward buying in 1988. Another version, kept by Leuthold/Weeden, highlighted a market bottom in late 1990, and sent a clear sell signal in May, 2000.

But as insiders increasingly use options to acquire shares, counts of buys are understated, making sell-buy ratios less reliable. When executives exercise options, their actions are not added to tallies of buying—even if they continue to hold shares. Analysts haven't found good ways to measure the significance of exercises amid differences in option terms and taxes, says Elliott. Yet when executives sell shares obtained with options, the sells are counted. Analysts make adjustments, but they can really

only guess how much more selling than buying is normal now.

Consider C.R. Palmer, chairman of driller Rowan Cos. and a veteran of 48 years in the oil business. In late June, Palmer exercised options on 122,000 shares of stock, two years before the options were set to expire. The purchase, with the stock 30% off its 52-week high, increased his holdings by 27%. Palmer says he's having to pay about \$9 a share in income tax on the exercise. His move was a big bet by an industry veteran that his stock will be higher a year from now. Yet it wasn't counted among buys. No one knows how many more bullish decisions similar to Palmer's go unrecognized.

CAUTION. To be sure, the lack of clear evidence of insider buying is a nagging concern and is discouraging analysts from forecasting a new bull market. Buying in July fell to \$78 million, the lowest amount since August, 1993. "It tells me they don't see the recovery as imminent," says Elliott. Says Lon Gerber, research director at Thomson Financial/Lancer Analytics: "There is a lot of caution. Nobody is making a commitment."

Energy execs are the exception. In July, insiders at Rowan, Baker Hughes, Anadarko Petroleum, Apache, and Burlington Resources made significant purchases. Energy execs tend to be savvy traders, says Gerber. At Anadarko, Executive Vice-President William D. Sullivan bought 10,000 shares in July for about \$56, or \$20 below the stock's 52-week high. The

\$560,000 purchase increased his holdings by 20%. Sullivan says he is taking advantage of Wall Street's underestimation of long-term demand for natural gas and overestimation of supply.

Ideally, executives will soon make more purchases like Sullivan's. That would give stocks a psychological lift. Meanwhile, considering how tough the market has been, investors can feel blessed that more insiders are holding tight to their stocks.

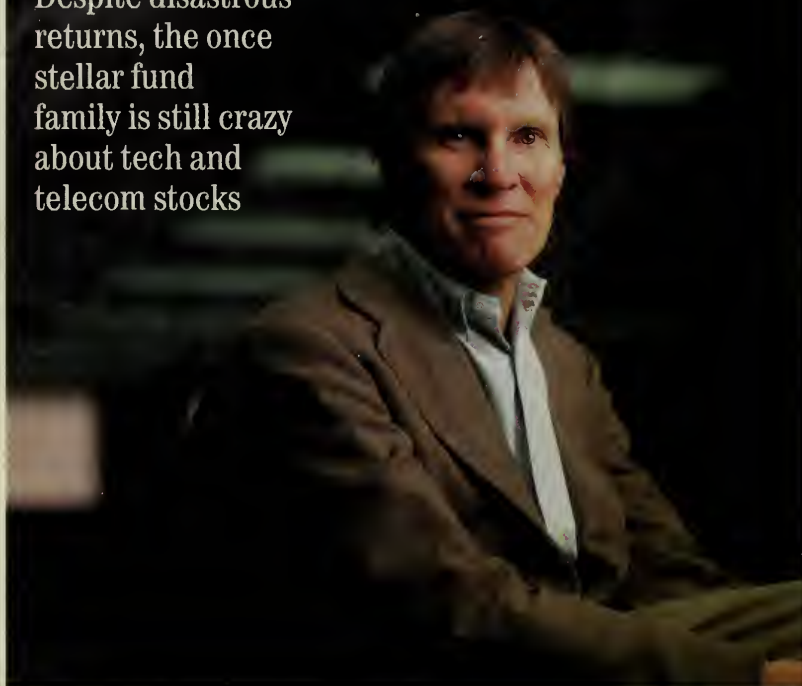
By David Henry in New York

es, counts of buys and sell-buy ratios become less reliable

MUTUAL FUNDS

JANUS TURNS OVER THE SAME LEAF

Despite disastrous returns, the once stellar fund family is still crazy about tech and telecom stocks



An odd thing happened on Morningstar's "Janus Junction" Internet message board in July. Once loyal investors of Janus Capital Corp., upset that the mutual-fund company was posting some of the worst returns in its 32-year history, started jamming the site with furious messages. The venom—"Janus sucks" was among the milder attacks—got so intense that fund-tracker Morningstar shut down the online forum for a day to let things cool off.

That's quite a turnabout for fund guru and founder Thomas H. Bailey. For much of the '90s, Denver-based Janus could do no wrong in the eyes of its 4 million adoring investors. Hot tech and telecom stocks picked by Bailey and his troupe of mostly twenty- and thirtysomething managers propelled Janus' Mercury and Twenty funds to the sky, with 96.2% and 64.9% total returns, respectively, in 1999. Such returns drove assets over a \$300 billion peak last year from just \$31 billion in 1995.

HOW JANUS' TOP 10 FUNDS STACK UP

FUND NAME	ASSETS BILLIONS	ONE-YEAR RETURN*	THREE-YEAR RETURN*
JANUS	\$30.9	-38.6%	4.9%
JANUS WORLDWIDE	24.9	-36.3	4.4
JANUS TWENTY	17.4	-49.0	-0.1
JANUS MERCURY	10.0	-43.9	11.5
JANUS GROWTH & INCOME	7.4	-26.2	9.8
JANUS OVERSEAS	6.0	-38.0	5.0
JANUS BALANCED	4.7	-9.7	10.0
JANUS ENTERPRISE	4.0	-58.3	6.1
JANUS OLYMPUS	3.9	-48.6	8.7
JANUS GLOBAL TECHNOLOGY	2.9	-63.7	Launched 12/31/98
JANUS GLOBAL LIFE SCIENCES	2.7	-16.1	Launched 12/31/98
S&P 500 INDEX		-22.1	7.5

*Through Aug. 17

Data: Morningstar Inc.

Those high-flying days are over. Some say Bailey may relinquish control by cashing out some of his 6% stake late this year. According to his contract, retaining the stake beyond Dec. 31 would cost him at least \$100 million because of the decline in Janus' earnings this year. And others wonder if Bailey's once high-growth shop is just a one-trick pony.

In the last 18 months, Janus has become an emblem of the tech wreck. "They just went overboard with tech and telecom, and that hurt them," says Morningstar analyst Christine Benning. Now, Janus' Mercury and Twenty funds are among the industry's worst performers with year-to-date losses of 28% and 29%, respectively. Overall, the Janus funds Morningstar tracks averaged a loss of 16%, year to date, worse than the 10.8% drop in the Standard & Poor's 500-stock index. And their performance in the past 12 months is even worse (table).



JANUS

Chairman Bailey may soon give up some control by selling some of his 6% share

small saving grade Returns beat the 23.5% loss by the Nasdaq composite index.

Bailey & Co. has been laboring mightily to turn things around. More "value" funds are on the roster. And they've slashed—in some cases, dramatically—tech positions. As of June, holdings in Cisco Systems—Janus' second-biggest holding last year—had fallen to 750,000 shares from 167 million. Managers now own far less EMC and Sun Microsystems shares, too, and they've upped positions in Boeing and Tyco, along with such blue chips as Citigroup, Exxon, and Pfizer. "We're so upset at the returns that we're working that much harder—I'm never going to take a vacation again until I improve the performance at the fund," vows Blaine P. Rollins, manager of the \$31 billion Janus Fund, the largest of the \$200 billion fund group.

RESILIENCE. But many Janus managers are still troublingly reluctant to part with the tech darlings that propelled them to No. 1 for so many investors. According to Morningstar, three of the group's largest funds—Rollins' Janus Fund, the \$10 billion Mercury, and the \$17 billion Twenty funds—still have more than half of their holdings in tech and telecom stocks, with the typical large-cap growth fund sporting a 31% tech weighting. The Janus Fund bought even more Linear Technology, Maxim Integrated Products, and Novell this year. Janus Mercury reduced Novell but added Juniper Networks, Openwa-



Biotechnology
researchers call it
"golden" rice.

For the color.
For the opportunity.

*"When mothers and their children eat
an adequate amount of vitamin A in
a daily meal, it could help alleviate
more suffering and illness than any
single medicine has done."*

The excitement expressed by plant biologist Charles Arntzen reflects the golden opportunity that many see in a new strain of rice being developed with biotechnology. "Golden" rice contains increased amounts of beta-carotene, a source of vitamin A. Because rice is a crop eaten by almost half the world, golden rice could help relieve a global vitamin A deficiency that now causes blindness and infection in millions of the world's children.

Discoveries in biotechnology, from medicine to agriculture, are helping doctors treat our sick, farmers protect our crops—and could help mothers nourish our children, and keep them healthier. To learn more about biotechnology and agriculture, visit our Web site or call us.

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Systems, Symbol Technologies, and ONI Systems, among others. And Janus Twenty added shares of Juniper Networks and Palm along with NTT DoCoMo. The group's all-time favorite stocks continue to be AOL Time Warner, Nokia, and cable outfit Comcast. Says Scott W. Schoelzel, who runs Janus Twenty, the firm doesn't make sector bets, but "digs deep" to find the best companies.

Janus investors have been remarkably resilient. Some started pulling out in June, 2000, and by December had cashed out \$3.2 billion—hardly a dent in the \$42 billion the firm attracted for the year. Investors pulled \$7.2 billion out through June of this year, more than offsetting \$5 billion in new retail money, reports Lipper Inc. Eight of Janus' most popular equity funds are closed to new investors, who might have counteracted outflows. Only 2% of Janus investors have closed their accounts so far. They may still be happy with the 12% gain that Janus funds have averaged over the past 5- and 10-year stretches.

CULTURE CLASH? Perhaps the biggest question now is whether Bailey, Janus' 64-year-old CEO, will wind down his role. He is expected to sell at least some of his remaining 6% stake in Janus because of a contract provision that allows him to sell at 15 times Janus' 2000 earnings by Dec. 31. If he doesn't sell by then, analysts estimate his shares will fall in value by more than \$100 million. If he cuts his stake below 5%, he would lose the legal control of the firm. "Historically, portfolio managers and analysts have been very loyal to him, and there's some question over defections if Bailey leaves," says Guy Moszkowski, analyst at Salomon Smith Barney. Bailey declined to comment for this story. He has told investors in the past it's unlikely that he'll leave the top job soon.

Bailey has no obvious successor: The previous candidate, well-regarded Chief Investment Officer James Craig, left last September to start a charity. And some people say Janus' parent, Stilwell Financial Inc., will move in and squash its maverick style. "Invariably, when control shifts to a conglomerate, the focus tends to be on profit generation, which could hurt the culture within Janus," says David Lackey, president of Weiss Ratings Inc. Stilwell declined to comment. By no stretch is Janus down for the count. With diversification, some of its funds could beat the market. But a repeat of 1998 and 1999 isn't likely. Says fund consultant Burton J. Greenwald: "That kind of glory isn't likely to be replicated; I don't think lightning strikes twice."

By Pallavi Gogoi in Chicago

COMMENTARY

By Stan Crock

DEFENSE: A MINEFIELD FOR INVESTORS

On the surface, the news about defense stocks looks bullish. The Bush Administration seeks a \$329 billion Pentagon budget for 2002, a hefty 9% rise from 2001. For months, Wall Street analysts, such as those at Lehman Brothers Inc., have predicted that arms procurement spending—the key to industry profits—will jump from \$62.1 billion in 2001 to \$85 billion in 2005. And despite campaign rhetoric about junking cold war weapons, on Aug. 17, Defense Secretary Donald H. Rumsfeld said: "We have not been talking about cutting programs."

Earnings look healthy, too. Analysts expect industry profits to climb 17.7% this year and 16.3% in 2002, according to First Call/Thomson Financial. Defense "is a relatively stable business, with long-term positive budget trends," says Clifford F. Ransom II of State Street Research & Management Co., an industry investor.

Yet a look behind all the good news suggests that things are not so rosy. For starters, defense stocks are in the stratosphere, despite recent weakness. The Standard & Poor's Aerospace & Defense Index has gained 44% since the market turn on Mar. 24, 2000—while the S&P 500-stock index has fallen 24%. More fundamentally, the defense sector may no longer be the safe, recession-proof haven investors have come to love. For the first time in memory, defense could be subject to the business cycle. As slow growth shrinks federal receipts and the budget surplus, the Pentagon is becoming vulnerable. As a result, "valuations are

really out of whack," according to Charles A. Gabriel Jr., a Prudential Securities Inc. analyst. They're fetching around nine times cash flow, their common valuation measure. That matches their 20-year high and is 50% above the 1990s average.

NOT SO FAST. High multiples may have been justified a year ago, as companies saw the fruits of a big increase in the weapons portion of the Pentagon budget, which soared from \$45 billion in 1998 to \$62 billion in 2001. In the short term, companies

will continue to benefit from outlays already in the pipeline. But that is about to change.

Just take a close look at the 2002 budget.

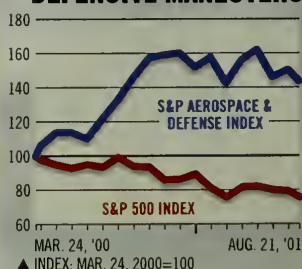
Even if the military gets its money, weapons makers would see little of the increase. Most of it would go for personnel and maintenance of bases and weapons. Low-margin research and development would rise, but profitable arms procurement actually would drop in 2002. Nor would 2003 look much better. Rumsfeld says the Pentagon would

need an additional \$18 billion for the defense budget to keep pace with inflation. With the budget surplus shrinking fast, as the White House conceded on Aug. 22, Rumsfeld is unlikely to see those dollars. Procurement in 2005 could stay closer to \$70 billion, way below what Wall Street expects. The bottom line: Anyone counting on defense stocks as refuges from a turbulent market could be disappointed.

Crock covers defense from Washington.



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URGENT MISSION

Don Dees is leading Chrysler's quality push, linchpin of its \$3.9 billion turnaround plan

other factory errors, says Sam Munro, president of Munro Associates Inc., a Troy (Mich.) based manufacturing consultant. The real problem, he says, is at the front end of the development process. "It has more to do with who designed it, how they designed it, and what processes and materials they used," Munro contends.

RAIDING TOYOTA. Now, in an effort to reduce costs and boost quality, U.S. carmakers are revamping their approach, trying to root out problems before assembly lines start rolling. They're borrowing strategies invented by the Japanese, or—in the case of Chrysler Corp.—raiding Toyota Motor Corp. for quality expertise. And they're bringing suppliers into the design

process earlier and treating them like partners, in hopes of spotting problems with components as early as possible.

Detroit is finding, as it did back in the 1970s, that there is no better way to begin than with a close look at Japan. There, top car builders take an evolutionary approach to design, stressing continuous improvement. From year to year, if parts are working well, they are kept, not replaced. And by using common components across a range of vehicles, Japanese designs cut down on variability—the old, familiar foe of quality.

In stark contrast, U.S. auto makers tend to start with a clean sheet of paper whenever they redesign a vehicle. And this can lead to trouble. When Chrysler introduced the redesigned 1999 Jeep Grand Cherokee, former CEO Robert Eaton bragged that there were so few shared bits between the new and old models, they'd all fit in a bag in his hand. He should have kept mum: *Consumer Reports* says the Grand Cherokee's "reliability has been among the worst we've seen."

Another nagging problem at U.S. shops is an overly narrow focus on component design without enough regard for the larger task of integrating parts on the factory floor. The trouble, points out Jay Baron, director of manufacturing systems group at the Center for

AUTO MANUFACTURING

CRUISING FOR QUALITY

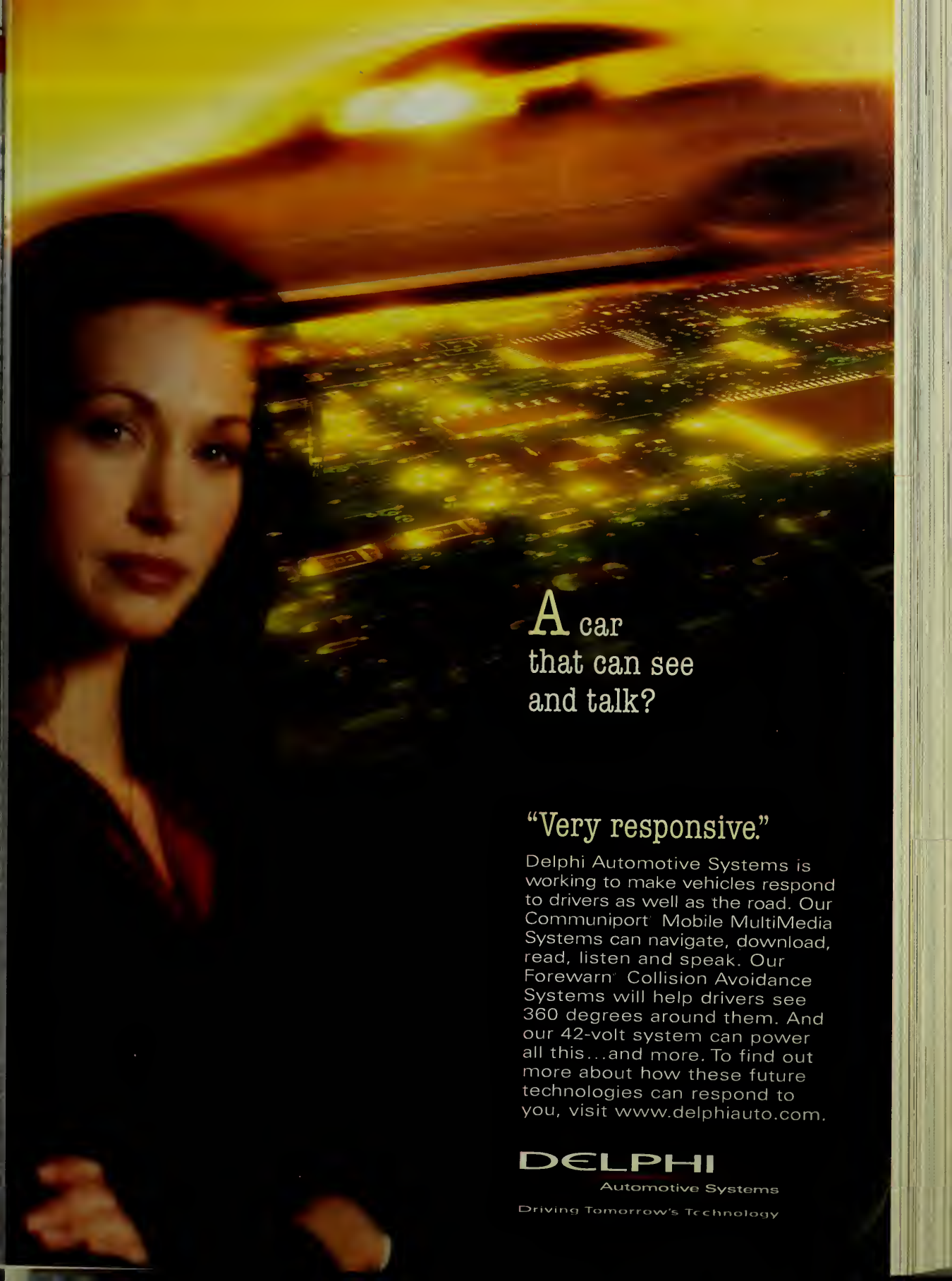
To catch up with Japan, Detroit redesigns how it designs

You'd think Ford Motor Co. would learn a lesson about keeping an eye on quality from the \$3.5-billion Explorer tire debacle. And, indeed, the auto maker went to extraordinary lengths to ensure that its revised 2002 Explorer launched without a hiccup. It even took the unprecedented step of holding up vehicles in the factory for engineers to pore over them for defects. But that wasn't enough. Last May, the new Explorer had to be recalled. It turned out that while redesigning the car, engineers forgot to adjust a rail used to guide the vehicle along an assembly line. The oversight meant that some Explorers limped off the line with nine-inch-long gashes in their tires.

Try as it might, the U.S. auto industry can't shake its karma for shaky

quality—even though its cars and trucks are better than ever. *Consumer Reports* recently found that the average number of problems per 100 new vehicles built by General Motors, Ford, and Chrysler dropped from 105 in 1980 to just 23 in 2000. But as the Explorer Redux episode highlights, U.S. cars still are not up to snuff. Despite the improvement, *Consumer Reports* pegs the quality of American vehicles at Japanese levels circa 1985. And the Big Three currently spend about \$125 more per vehicle in warranty costs than their Japanese rivals.

Why the gap? It's not that American factory workers are sloppier than their Japanese counterparts. In fact, fewer than 15% of quality problems can be traced to shoddy workmanship or



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DELPHI

Automotive Systems

Driving Tomorrow's Technology

Automotive Research in Ann Arbor, Mich., is that good components that don't fit together demand costly last-minute design changes. "This is one area where the Japanese are way ahead of us," says Baron. Instead of striving for perfection in the design of each component, the Japanese fast-forward to the manufacturing phase to make sure the parts fit, and then back up to make necessary adjustments, he says. Now, all three Detroit auto makers are beginning to follow suit.

TRICKY PROBLEMS. Ford, by any calculation, needs the most work. Last year alone, recalls and other quality gaffes cost the company at least \$1 billion, says CEO Jacques A. Nasser. Now, Ford is pinning its quality hopes on Six Sigma, a data-driven method pioneered by industrial giants such as AlliedSignal Inc. and Motorola Inc.

It's an approach that depends on rigorous statistical analysis to unearth tough problems. And it's already helping crack some tricky ones at Ford. Ill-fitting doors on Ford's top-selling F-150 pickup truck, for example, were blamed for chronic wind noise and leaks. So, after studying the installation of hundreds of such doors, a Six Sigma team working at Ford's Norfolk (Va.) truck factory discovered that door-fit varied according to the order in which bolts attaching the door to the frame were driven in.

The problem implied its own solution. Experimenting with various sequences, the team reduced the defects rate by two-thirds—without changing a single part. The change immediately saved \$35,000 on the plant floor by eliminating the refitting of bad doors. Larger savings in warranty haven't yet been tallied.

The truck team passed along its findings to other Ford truck plants and to teams developing future models. Ultimately, catching potential problems while the designs are still just sketches gives the biggest payoff. "In existing product, problems are easy to find, but hard to fix," says Louise Goesser, Ford's quality vice-president. "In future product, problems are harder to detect, but easier to fix."

Of the Big Three, GM

has made the most progress on quality. This year, it climbed to No. 4 on J.D. Power & Associates' annual overall quality rankings, just a notch behind Nissan Motor Co. Now, GM is looking to close in on the leaders, Toyota and Honda, by working more closely with its suppliers, says GM manufacturing chief Gary Cowger. On some vehicles, GM is even handing over complete design responsibility for its interiors to large suppliers, such as Lear Corp. and Johnson Con-

later on. Even before Zetsche arrives, Chrysler quality was improving: Dodge Intrepid beat out the Toyota Camry and the Honda Accord—longtime leaders in the midsize sedan segment—in J.D. Power's 2001 new car quality survey.

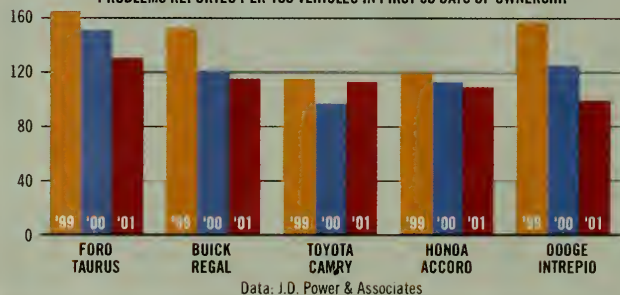
Chrysler also is adding more discipline to the development process by borrowing Mercedes' system of "quality gates." This refers to a series of dozen or so checkpoints throughout the



QUALITY QUOTIENTS

AS THEY FACE OFF WITH JAPAN IN THE MIDSIZE-SEDAN MARKET, DETROIT'S COMPANIES ARE MAKING BIG STRIDES IN QUALITY

PROBLEMS REPORTED PER 100 VEHICLES IN FIRST 90 DAYS OF OWNERSHIP



trols Inc. The subcontractors, GM figures, can better monitor quality by designing and building fully integrated systems—complete seats or dashboards as opposed to just seat frames or speedometers.

At Chrysler, the struggling U.S. unit of Germany's DaimlerChrysler, improving quality is an even more urgent mission. The company's new CEO, former Mercedes chief engineer Dieter Zetsche,

has made it a cornerstone of his \$3.9-billion turnaround plan. He's overhauling Chrysler's vehicle development processes by pulling together teams from all areas of the company—design, engineering, marketing, manufacturing, and purchasing—in a bid to drive out waste. By involving everyone up front, his goal is to avoid the kinds of last-minute design changes that lead to errors

the influence to encourage sharing.

Some quality problems may still find their way into vehicles. But Chrysler is trying to identify them earlier—fix them faster—at its new quality engineering center near its Auburn Hill (Mich.) headquarters. There, some 15,000 company-owned cars are serviced. The center also receives and scrutinizes every faulty part that is removed from a car at Chrysler's 4,600 dealers nationwide. That helps engineers quickly identify problems in the field and work with suppliers to find a solution. "As you think things, you put that in your book of knowledge so you don't make the same mistake on the next vehicle," says De-

Sounds good. But Detroit has already shown that learning from its own mistakes is easier said than done. What's more, it remains to be seen whether Big Three can turn the still harder task of learning Japan's best practices to

By Joann Muller, with Katie Kwin, in Detroit

DODGE INTREPID

Chrysler's once problem-prone sedan now leads in reliability

three-year vehicle development process. The concept is simple, says Don Desautels, the quality guru Chrysler hired last year from Toyota. "You don't go through the gate if you're not ready. Otherwise, you have warranty problems for the customer."

Chrysler also expects to boost quality by sharing more parts among its vehicles and borrowing more components from Mercedes. Until now, some Mercedes execs were slow to release certain technologies as components to their counterparts at Chrysler. But Zetsche, who joined Chrysler in November, has

GM, working closely with suppliers, has made the most progress among the Big Three



ENERGY

THE MOST FUEL-EFFICIENT THAT YOU CAN BE

Defense Dept. report says the military is wasting billions

about the only thing that could stop an Abrams tank as it lumbered across Iraq during Desert Storm was running out of fuel. To keep that from happening, U.S. Army troops continually built roads, keeping supply trucks close. But the tank's enormous thirst for fuel—it gets 0.2 mile per gallon—slowed the Army's advance and increased the mission's costs. "About 80% of what you move into a theater is other than combat systems. And a large part of that is fuel and the equipment to use it," says Lt. General Paul J. Kern, acquisitions and logistics expert for the Army.

That's typical of the problems identified in a new Defense Dept. report titled *The Capable Warfighting Through Reduced Fuel Burden*. The report, which has been circulated among government officials and was obtained by *BusinessWeek*, finds that gas-guzzling vehicles, aircraft, and ships are wasting billions of dollars while decreasing military effectiveness. The range of many weapons is limited by the capacity of their fuel tanks, and efforts to resupply them create a military Achilles' heel.

The report, prepared for the Defense Dept. by a team of researchers, business leaders, and former military personnel,

argues that the Pentagon has "overlooked the substantial performance gains that can also be achieved through energy efficiencies," including "greater range, lighter weight systems, and reduced combat vulnerability."

"If you can reduce the amount of fuel usage on the battlefield, you need fewer fuel trucks, drivers, and crews—and you don't need all that training," says Vice-Admiral Richard H. Truly, director of the National Renewable Energy Laboratory in Golden, Colo., who led the report task force. The Pentagon did not respond to requests for comment.

POWERFUL PUNCH

Adopting these new technologies could improve the military's effectiveness:

HYBRID ELECTRIC MOTORS Get better mileage and supply electricity

UNMANNED AIR VEHICLES Cheaper to build and operate

SMALL FUEL CELLS Use cheap methanol

DELIVERY BILL: It costs \$17.50 a gallon to refuel in the air

Among the task force's other findings: ■ Even small gains in fuel efficiency can lead to major reductions in infrastructure support and personnel. Putting more efficient engines in the B-52H bomber, for example, could save \$9 billion in reduced fuel, resupply, and equipment costs.

■ Because the huge cost of delivering fuel to vehicles is not included in the cost of weapons systems, efficiency benefits are undervalued.

■ Mandating fuel efficiency would improve the design of new weapons and retrofits for existing weapons systems.

■ Defense Dept. accounting and allocation processes fail to reward energy efficiency.

The military spent \$3.6 billion for 4.4 billion gallons of fuel in fiscal year ended last September, but that was only a tiny portion of the fuel bill. Far more money was spent on delivery. The Defense Dept. sells fuel to the services at a set price: This year it's \$1.01 per gallon. But the Army estimates that the true cost, including delivery, is closer to \$13 per gallon. And that rises to hundreds of dollars per gallon for delivery to war zones. For the Navy, which consumes more than a third of the fuel used by the armed services each year, costs depend on the location of the fleet. The Air Force—the military's largest consumer, at two billion gallons a year—spends most of its fuel-delivery budget refueling planes in the air, at a cost of \$17.50 per gallon.

VALUABLE. But cost isn't the only issue. The Defense Dept. report found that fuel-hungry weapons systems actually decrease military effectiveness. For example, 70% of total equipment tonnage shipped during the six-month deployment before the Persian Gulf war was fuel. In a study cited in the report, the Army Research Laboratory concluded that if the Abrams tank had been 50% more fuel efficient—and the technology exists today to make it so—the setup time for the gulf war would have been reduced by a full month. And the tank's range would have doubled, too.

The DOD report was commissioned in 1999, during the Clinton Administration. But it could be a valuable tool for the Bush defense team, which is looking for a way to slash costs while modernizing forces.

Fuel efficiency has never

ABRAMS TANK: It gets just 0.2 mile per gallon



been a military priority, largely because the Pentagon's accounting system considers fuel purchase costs separately from delivery costs. That may have played a role in a 1997 decision by the Air Force not to install more efficient engines in the B-52H bomber. The Air Force analysis assumed a fuel cost of 93¢ per gallon and found that savings would be small—only \$400 million over the 40-year lifetime of the fleet.

REALISTIC. Yet, when the report task force re-ran the analysis—using realistic costs and assuming that 10% of the fuel would be delivered by airborne tanker at \$17.50 a gallon—the savings reached \$1.7 billion. Further analysis showed that 55 refueling tankers could be removed from service, saving an additional \$154 million annually or \$6 billion over the fleet's 40-year lifetime. And having those tankers available for other duty—say, refueling F-22s or Stealth bombers—eliminated the need for 55 new tankers. Overall, the task force found potential savings of \$9 billion, not considering such benefits as better engine reliability or longer flying ranges. (Fuel-efficiency is only one factor to consider; older weapons present other issues, including higher maintenance costs.)

The report underscores the need to accelerate energy-efficiency efforts now under way. The Army just gave the go-ahead to upgrade the Abrams tank with an engine that could improve fuel use by up to 35%. Weapons designers point to new systems that are smaller, lighter, and powered by alternative fuels. "Five years ago, remotely piloted aircraft were not taken seriously, no matter how obvious a solution they were. Now, people aren't questioning it," says Paul B. MacCready, task force member and CEO of AeroVironment Inc., which makes such planes in Monrovia, Calif.

The military is also looking at hybrid electric engines and fuel cells. Not only is the mileage of a hybrid Humvee better by some 25%, but the electric engine also serves as a portable generator. The Defense Dept. has a prototype 60-watt, methanol fuel cell that can run a laptop computer for 100 hours on 1 kilogram of fuel. It weighs 15 pounds and replaces the need for dozens of heavy lithium batteries soldiers must now carry into battle.

As Defense Secretary Donald H. Rumsfeld prepares the Quadrennial Defense Review to present to Congress next month, he faces a thorny political dilemma: how to hold the budget while modernizing the military. The DOD report suggests that a fundamental shift in focus toward energy efficiency might be a big part of the answer.

By Janet Ginsburg in Chicago

Entertainment

ONLINE MUSIC

CAN'T GET NO...

The recording industry tries, and it tries, but will post-Napster models work?

An auspicious debut it wasn't. Here was RealNetworks Inc. CEO Rob Glaser (*e.biz* Cover Story, opposite page 54) standing before more than 350 music executives in late July at the Sheraton in midtown Manhattan. The idea was to offer a glimpse of closely guarded MusicNet, one of the two big-league online music ventures pushing to launch this September. Glaser, whose company will provide the streaming technology, was all set to tee-up Britney Spears's hit "...baby one more time" for the high-powered audience. But he couldn't log on to his laptop. It took an assistant to help him finally reboot. By the time Britney was through a few verses, it was clear the crowd was thoroughly underwhelmed.

The half-baked demo may be a sign of the sour notes to come when the music industry makes its first serious foray online. Now that the Napster pirating service that revolutionized the distribution of music has been shut down, the major record labels are testing the uncertain notion that folks will now pay for what they once got for free. But even before the first song gets downloaded, the two services face more obstacles than rapper Eminem at a women's rights conference. Antitrust agencies in Washington and Europe are investigating the services, Congress is considering legislation to ensure fair competition, and music publishers could sue to shut down the sites over money they say they will be owed for each

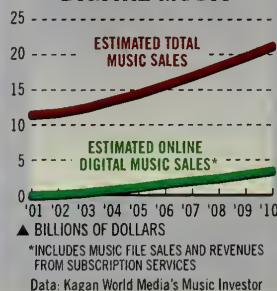


song sold online. "It's just a real mess right now," says Derek Baine, editor newsletter *Music Investor*, publisher by consultancy Kagan World Media. don't see how this can work."

Driving much of the concern is the fact that the two services control 8% of music sold today. MusicNet is backed by Warner Music Group (a division of AOL Time Warner), EMI Group, and B

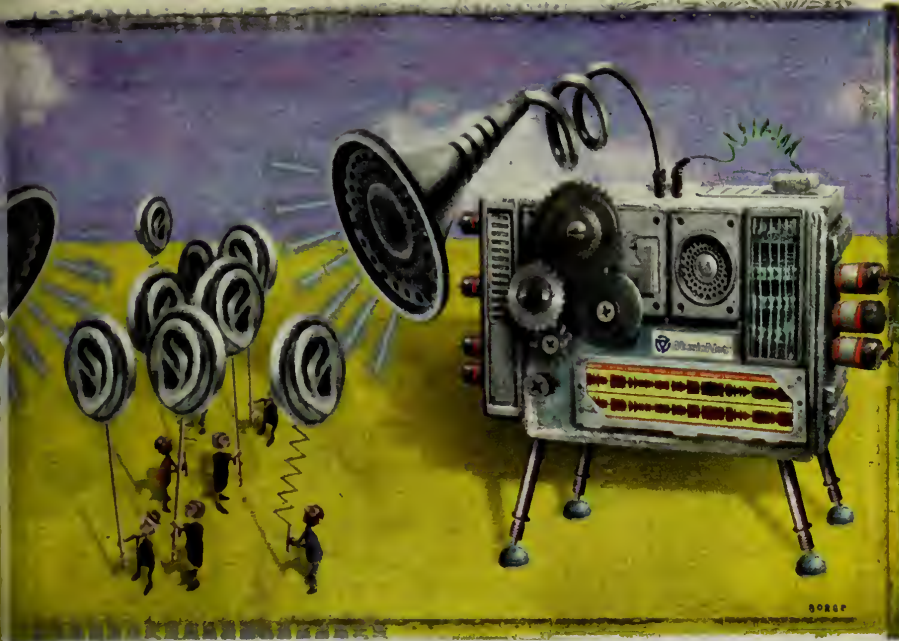
Entertainment (a unit of German media giant Bertelsmann). Rhapsody is a venture partner of Universal Music Group (part of Vivendi Universal) and Sony Music Entertainment. Those combinations have regulators and Congress worried that competition will be blocked from entering an online market that by 2010 will account for 16% of the \$21 billion in U.S. music sales.

SLOW START FOR DIGITAL MUSIC



projects Kagan World Media.

"FATAL FLAW." Just as problematic as the services is the fact that still-heated rivalries within the music world have far stopped the two groups from cross-licensing music to each other. That means that for the \$10 to \$15 a month the services are expected to charge, a consumer might get songs from Shaggy and Bli182 but not from the Dave Matthews Band and 'N Sync. That would make each service akin to a radio that gives only half the stations. The services, at least initially, will not allow music to be burned to CDs or loaded into portable players. The tunes downloaded or streamed will expire after a certain time period. "It's absolutely a fatal flaw," says



club.com, a Universal Music site, for failing to pay for songs. That suit is still pending. "All we are asking for is the same arrangement for the Internet that exists everywhere else in the industry," says Chris Amenita, senior vice-president of the American Society of Composers, Authors & Publishers, which collects a royalty each time a song is played on the radio or elsewhere.

MUCH ADO? Without some deal with the music publishers, the labels likely won't be able to launch the services, says Cary Sherman, general counsel of the trade group Recording Industry Assn. of America (RIAA). One way out

n C. Pohlmann, a University of Miami professor specializing in digital music. What could complicate doing any licensing deals in the future is that two services have different business models. MusicNet will act more like a traditional record business, selling music wholesale and letting its online distributors, such as AOL, set the price to consumers. That's similar to the relationship today between music companies and a retailer such as Tower Records. In contrast, pressplay will have arrangements with its distributors more like those between airlines and travel agents. Pressplay will set its price, and its online distributors, such as MSN and MP3.com, will take a commission on sales. Edgar Snodman Jr., executive vice-chairman of pressplay partner Vivendi Universal,

says he wants to control pricing for fear that AOL will sell music at deep discounts as a loss leader for its other online businesses. "If you allow music to be used to promote other business models, it devalues music," he says.

As they prepare to test those models though, the online services face a head-banging from music composers and publishers who claim the new ventures will owe them royalties. That demand is especially ironic given the labels' recent hounding of Napster over the very same issues. This time around, the services launched by the labels are being pressured to pay as much as 7.5¢ per song sold online, the same "mechanical royalty" they pay each time a song is reproduced on a CD or cassette. Last year, the National Music Publishers Assn. sued Farm-

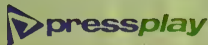
might be for the two sides to agree to have the U.S. Copyright Office set royalty rates. But no rulemaking is likely to stop the ongoing pressure from Congress, the Justice Dept., and the European Union. Regulators say there's little evidence that the major labels are playing fair. So far, only one small independent online music company, FullAudio, has struck a licensing deal with big labels—BMG and EMI. Because the industry hasn't shown more openness to small players, Representative Chris Cannon (R-Utah) introduced legislation Aug. 3 designed to stop major labels from striking "sweetheart deals with each other." The record industry is calling for some perspective as lawmakers consider new copyright rules this fall. "With all that's going on in Congress, you would think we were talking about world hunger," says the RIAA's Sherman. "We're talking about the music industry."

For now, record execs would be happy just to get their services off the ground and start finding customers—a big challenge in itself. At its height, Napster perhaps had 70 million users, none of whom paid a cent to download nearly unlimited amounts of music and then swap files with pals. Several Napster clones still draw music fans. Pressplay and MusicNet figure consumers will pay something for a quicker service that offers secure downloads of complete songs, ensuring against the song fragments that plagued Napster. How many will sign up? Neither company offers projections. But with so many hurdles yet to cross, it may be a while before customers even know they exist.

By Ronald Grover in Los Angeles and Tom Lowry in New York, with Arlene Weintraub in Los Angeles

DECISIONS, DECISIONS

Online music fans will soon have two rival services to choose from:

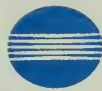
		
OWNERSHIP	Universal Music, Sony Music	RealNetworks, EMI, BMG, Warner Music Group, Zomba
DISTRIBUTION AGREEMENTS	Yahoo!, MSN, MP3.com	AOL, RealNetworks, Napster*
LAUNCH DATE	Early to mid-September	Mid-September
BUSINESS MODEL	Will serve as a consumer service, setting prices for distributors	Will act as wholesaler of online music, letting distributors set price
PRICING	Not yet disclosed	Not yet disclosed
ARTISTS YOU CAN'T GET	Christina Aguilera, Britney Spears, 'N Sync, Madonna, Dave Matthews	Aerosmith, Blink-182, Limp Bizkit, Michael Jackson, Ricky Martin

* compliance with federal law

Source: RealNetworks, pressplay, *BusinessWeek*

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MINOLTA

The essentials of imaging

As he looked out over the perfectly manicured grass of the driving range at Augusta National, perhaps Sam Snead wasn't really there. Perhaps, in his mind, he was a kid again, sneaking in a quick three on an overgrown course so steep it was nicknamed "The Goat Course." Either way, he was swinging like he was a kid.

At 8:35 A.M. on Tuesday, April 3, 2001, Sam Snead stepped onto the range to hit a few balls and to say a few hellos. He ended up putting on a swing clinic. Very few golfers swing sweet enough to make people stop and take notice. Only one can still do it at the age of 89. As Sam took his place and started to hit, one by one, Palmer, Watson, Faldo and every other pro put their clubs down and gathered around, showing their respect and admiration for the greatest swing in golf history.

As ball after ball sailed into the sky, Sam raised his head and watched every ball find a home in that great green expanse of grass.

He later admitted that at his age he couldn't see exactly where they landed. But he didn't need to.

"All I saw was green. But I could *feel* they were all good."

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IN GERMANY: Rocky acquisitions made for losses of \$200 million last year

STRATEGIES

HOW WELL DOES WAL-MART TRAVEL?

After early missteps, the retailing giant may finally be getting the hang of selling overseas

In the decade since Wal-Mart Stores Inc. began its international exploits with a joint venture in Mexico, its record abroad has been full of merchandising missteps and management upheaval. Such blunders explain why German shopper Claudia Gittel grouches about the meat selection at the Wal-Mart in Esslingen and how the prices were lower when local chain Interspar ran the store. And why rival retailers from Brazil to South Korea scoff at Wal-Mart's product choices and "cookie-cutter" outlets. "We don't see Wal-Mart as a threat anymore," sniffs Hong Sun Sang, assistant manager for E-Mart, a 35-store chain in South Korea.

But with its persistence and deep pockets, it would be a mistake to underestimate the world's largest retailer. Just look at the U.S. grocery business, where Wal-Mart is a leader after early

stumbles with its huge "supercenters." Likewise, the Bentonville (Ark.) chain has learned some painful lessons about consumers, regulators, and suppliers around the world. Through trial and error, the company has quietly built a powerful force outside the U.S. It's now the biggest retailer in Canada and Mexico. Its \$32 billion international business equaled 17% of its \$191 billion in sales last year, with more than 1,100 stores in nine countries. And its operating prof-

it abroad rose 36% last year, to \$1.1 billion, about 12% of total profits. The trend continued in the first half of this year, with international sales rising 9.6% and operating profit jumping 39%.

Wal-Mart finally started getting its international act together two years ago after it ousted then-chief financial officer John B. Menzer in charge of the International Div. The low-key Menzer was credited with tightening financial discipline and boosting return on assets for the parent company. Now he's bringing a similar focus to Wal-Mart's sprawling operations abroad, where he's pushing more authority into the field, working

to develop a corps of top managers, and spreading "best practices" from the U.S. and elsewhere around the world. And for the first time, Wal-Mart is building a global sourcing operation to use its huge sales volumes to command better deals, higher quality, and more innovation from both U.S. and foreign suppliers.

The company is backing these efforts with big bucks. Lehman Brothers Inc. estimates that Wal-Mart will devote 2% of its \$9 billion in capital expenditures this year to operations abroad, adding about 120 stores. "As a global organization, they've become more savvy," says Ira Kalish, director of global retail intelligence at PricewaterhouseCoopers.

Wal-Mart believes that it has no choice but to expand rapidly abroad. Its culture and stock price are built on the expectation of double-digit sales and profit gains year after year. Analysts figure that the company's expanding chain of U.S. supercenters will carry the burden for at least four to eight years. But "someday the U.S. will slow down, and international will be the growth vehicle for the company," says Menzer.

Still, to get there Menzer must clear some high hurdles. The biggest one is in Germany, where Wal-Mart bought a 21-store Wertkauf hypermarket chain in 1997 and then 74 unprofitable and often decrepit Interspar stores in 1998. Problems in integrating and upgrading the stores resulted in at least \$200 million in losses last year, on roughly \$3 billion in sales, estimates analyst Robert Buchanan of A.G. Edwards & Sons. Wal-Mart has stopped predicting what it might make money in Germany. So analysts believe that it won't break even

WAL-MART'S NEXT GROWTH ENGINE?



Data: Lehman Brothers Inc.

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BIG BUCKS Wal-Mart will devote some 26% of its \$9 billion in capital expenditures this year to operations abroad, adding about 120 stores

until at least 2003. "There was a steep learning curve that wasn't expected," says Jim Leach, portfolio manager at shareholder Strong Capital Management.

Many of the wounds were self-inflicted. Wal-Mart failed to understand Germany's retail culture, the regulations that can add five years or more to the launch of a new hypermarket, and the stiff competition among some 14 hypermarket chains in a stagnant market. German managers who had been running the Wertkauf and Interspa stores for years didn't always take kindly to American "mentors" who were telling them how to do things when they didn't even speak German. Vendors balked at switching to a new supply system; when Wal-Mart tried to force them to supply its new centralized warehouses, it often found itself with empty shelves.

Then, last September, the German Cartel Office compelled Wal-Mart and some rivals to raise prices on milk, butter, and some other staples that they were found to be selling below cost. Wal-Mart denies that but admits it underestimated the difficulties it would face. "We just walked in and said, 'We're going to lower prices, we're going to add people to the stores, we're going to remodel the stores because inherently that's correct,' and it wasn't," says Wal-Mart CEO H. Lee Scott Jr. "We didn't have the infrastructure to support the kind of things we were doing."

FOOD STUFF. Wal-Mart still needs a bigger presence in Germany to compete effectively, many analysts and suppliers contend. They point especially to food, where its market share is put at less than 2%. But Wal-Mart executives insist that they don't need more stores to make the German operation a success. "We have the scale; we just have to operate better," says Menzer.

To fix those operational problems, Wal-Mart recently hired a new country head, poaching him from a German tobacco-and-food supplier. Instead of the expensive renovations completed on 24 stores last year, Wal-Mart is carrying out more modest face-lifts on 35 outlets this year. And this year it will open its first two new stores since the acquisitions. Wal-Mart is also working more closely with suppliers to boost its centralized distribution effort. About 50% of the products

Wal-Mart has targeted for the program now move through central warehouses. Says Menzer: "We set ourselves back a few years, and now we're rebounding."

Wal-Mart executives say the German experience helped when they bought the British chain ASDA in 1999. Wal-Mart acquired a strong chain and gave local managers the freedom to run the business. While ASDA is still No. 3 in the grocery market, its share grew from 7.4% in 1995 to 9.6% last year, according to Verdier Research. Wal-Mart gave ASDA better technology for tracking store sales and inventories. And it pulled ASDA into its global buying effort, led by a 40-person unit in Bentonville that helps negotiate prices for products that can be sold in different markets. This enabled ASDA to cut prices on fans and air conditioners, for example, by 50%, boosting sales threefold.

Perhaps most important, says ASDA President Paul Mason, "this is still essentially a British business in the way it's run day-to-day." Indeed, one of Menzer's main priorities is to push operational authority to the country chiefs and closer to customers. That has meant cutting the international staff in Bentonville from 450 to 137. Now, Menzer focuses on enforcing certain core Wal-Mart principles, such as "every day low pricing," recently rolled out in Mexico and Argentina. But country managers handle their own buying, logistics, building design, and other operational decisions. "I have the autonomy to do what I need to do to run Wal-Mart Canada," says Mario Pilozi, president of that business. In contrast, when Wal-Mart entered Canada in 1994, its blueprint specified what to sell and where to sell it—including liquid detergent and Kathie

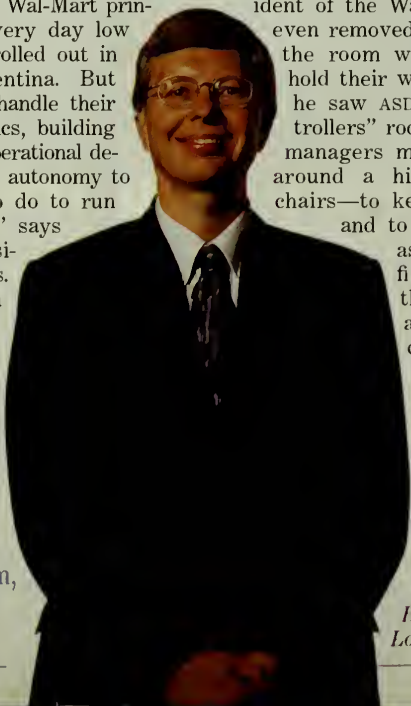
MR. FIXIT
Menzer gives foreign managers more freedom, while enforcing core Wal-Mart principles

Lee clothing that flopped there. In the past, says CEO Scott, "we could get very specific on what should be on an end cap [a store display at the end of an aisle].... I think we've matured."

Still, critics believe that the company retains a headquarters-knows-best mindset. That raises the question, is Wal-Mart truly a global company, or just a U.S. company with a foreign division? Vijay Govindarajan, a professor of international business at Dartmouth College's Tuck School of Business, says Wal-Mart has few top managers who aren't American and few who speak more than one language and have been posted in several spots abroad. That might be one reason why some competitors scoff at Wal-Mart's claim that it's now sensitive to local tastes. "I have the impression that Wal-Mart is insisting on the American-style layouts and business approach," says Seol Do Won, marketing director at Samsung Tesco Co. in South Korea, which runs seven Ho Plus stores. "It's good to introduce global standards, but you also need to adapt to local practice," he says.

Menzer insists he's doing just that and that the lessons are flowing back to Bentonville, too. The U.S. stores are adopting ASDA's system for replenishing fresh food more quickly and in the right quantities. And ASDA's popular line of George brand clothing is being rolled out in the women's department of all U.S. stores this Christmas season. Thomas M. Coughlin, president of the Wal-Mart Stores Division, even removed all the chairs from the room where his managers hold their weekly meeting after he saw ASDA's "air-traffic controllers" room in Leeds. The managers meet every morning around a high table with chairs—to keep meetings short and to encourage action as they pore over figures charted on the walls. As Menzer and Scott have made clear, there's no turning back in Wal-Mart's plan to conquer the world.

By Wendy Zerner in Bentonville, Ark., with Katharine A. Schmitt in Esslingen, Germany, Moon Ilwan in Seoul, and Heidi Dawley London



From Hammer to Handshake

The Power of Purchasing

Written by: Mark Fagan & Diane Glynn, Norbridge, Inc.

8% at DuPont.
2% at Compaq.
5% at Fleet Bank.
0% at IBM.

What are they reporting? The savings generated through the application of improved procurement.

Purchasing, strategic sourcing, procurement, or just plain buying – the action goes by many names but results are always the same – adding value to the bottom line.

Some Things Old, Some Things New

"Negotiate with our suppliers as aggressively as our customers are negotiating with us!" That's been the challenge for many CEOs to their procurement staffs in the past decade. Purchasing organizations have met this challenge by introducing best practices that have generated huge savings. The best practices range from standardizing specifications, to evaluating total life cycle costs, to sourcing from the global marketplace, to decomposing supplier costs, to developing quality suppliers. Savings of 10 percent and greater have been routinely realized through a combination of hammer and handshake best practices. The emergence of e-procurement has added new tools such as, reverse auctions, aggregated volumes, and (inexpensive communications) that enable more companies to implement best practices and save money.

Best Practices "Triple Benefits"

The starting point for implementing best practices focuses on contracting

with practices ranging from leveraging all volumes to aggressive fact-based negotiations.

Contracting Best Practices Checklist

- Leverage all volume and suppliers
- Negotiate aggressively from a fact base
- Ensure competition
- Evaluate total cost
- Source from global marketplace
- Develop strategic suppliers
- Pursue continuous shared cost elimination

Source: Norbridge, Inc.

Many companies have launched initiatives to consolidate supplier relationships and focus spending with strategic sources. These efforts yield triple benefits according to William Schaefer, Vice President of IBM Global Services' Procurement Services division:

- Lower unit costs (from 5 to 25 percent reductions)
- Improved quality, availability, and collaboration with suppliers
- Reduced administrative effort

Paul Box, Compaq's purchasing head, echoes the need to consolidate suppliers. "Compaq has 33,000 active suppliers; 2000 account for 80% of our spend. Our goal is to rationalize the total supply base to drive meaningful, incremental spend toward our core of preferred suppliers."

At the other end of the spectrum is the challenge of sole-source buying. In this case, more suppliers are needed to ensure a competitive environment. One powerful source, Thomas Register (TR), the "buyers' yellow pages," provides 72,000 product and services headings and lists more than 173,000 companies. "We

list both large and small manufacturers, and you can search all of them by company name, product or service, brand, and location. It's an immense array of potential suppliers, available to the buyer in a fast, easy-to-use fashion," states Alisa Fogel, Director of Marketing for Thomas Register.

Strength – and Savings – in Numbers

Global sourcing is emerging as a very powerful best practice in the contracting arena. Tapping the worldwide marketplace is allowing companies to:

- Find additional suppliers
- Access leading-edge technology
- Reduce total costs
- Meet localization requirements

Continental Airlines gets its small-plane engines repaired by Volvo in Sweden and gets its DC-10s repaired in Tel Aviv. One of the reasons Continental finds this attractive is that offshore companies often take a longer-term profit perspective, which provides better capital investment, resulting in greater efficiency.

These global sources are also introducing new ways to do business. Chuck Wodehouse, President of CSX Technology, reports that an Indian firm remedied 50 million lines of code for Y2K. The quality of the effort was terrific with an error rate below 2 percent. The time difference allowed 7 x 24 coverage and the cost benefit exceeded 25 percent.

Procurement – A Lifetime Event

The discussion of contracting best practices is incomplete without introducing total life cycle costs. Most purchasing executives are focused on minimizing the total expense of materials and services, not first costs. At Peabody Energy Corporation,



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ng equipment is purchased based on a cost approach that includes the initial of the equipment and the projected of maintaining it throughout its useful Ron Osborn, who heads Peabody's hasing function, has successfully atiated full life cycle costs of equip- at the time of initial purchase, when age is greatest. Continental Airlines focuses on purchasing as a support to evenue-generation side of the business. Tsuruta, Sr. VP of Purchasing & erials states, "Our objective is to ize aircraft downtime and optimize .. Purchasing's role in this is to buy best quality product at the most nable price."

To be blunt, purchasing executives have a hammer at their disposal. hough aggressive negotiations, intro- ing new competitors, and consolidat- volume, companies have achieved 10 0 percent cost reductions largely h suppliers reducing margins. "The first wave of pain is the lier's," says Tariq Hassan, Managing ctor, Global Procurement at Fleet t. "In the second wave, where we on requirements planning practices, ain is the user's." The requirements ing best practices focus on product fications, the use of generic products, collaborative planning.

Requirements Planning Best Practices Checklist

- Standardize products
- Review specifications; participate in design
- Share forecasts with suppliers
- Evaluate outsourcing
- Optimize usage
- Participate in all purchases
- Obtain vendor input

Source: Norbridge, Inc.

Collaborating with suppliers about requirements is a powerful practice that s purchasing professionals reduce s. Linwood Stockwell, who leads ly management at National Grid, ins. "It represents a commitment from endor," he says, "to hold specific pro- on capacity awaiting our instructions month. In return, rather than allow day-to-day demand to drive periodic

replenishments, we combine our needs into a single monthly order." The theme of these practices is the handshake – buyer and supplier working hand in hand to reduce costs.

"Mid- to long-term, SAP's electronic procurement will save us \$1.5 to \$3 million a year."

– Norbert Litzkow
Head of Procurement, Finance,
Controlling & Information Technology
Mercedes-Benz España

Take It Outside

Outsourcing is a hot topic for procurement heads and general management. The rationale for outsourcing includes:

- Focus management attention on the core business
- Tap outside expertise
- Adapt quickly to changing business conditions
- Avoid investment costs
- Reduce expenses
- Turn fixed costs into variable costs

DuPont's outsourcing of its out-bound logistics and import/export business on a global basis illustrates the reasoning. "We realize," says Henri Irrthum, DuPont's Vice President of Global Sourcing and Logistics Services, that "we can't be smart on everything worldwide – we have to rely on people who [import/export] as their core business."

The E-Procurement Boost

E-procurement has become an enabler for many of the best practices as well as a best practice in its own right. The power of the Internet is used to:

- Improve communications with suppliers
- Eliminate "maverick" buying
- Lower the costs of goods or services purchased by:
 - Supply base rationalization
 - Collective purchasing power
- Lower inventory levels and order lead times
- Shift the focus of purchasing personnel from tactical to strategic activities

Automate and Control with mySAP E-Procurement

Company: Mercedes-Benz España produces 90,000 Vito and V-Class vans per year – and demand is rising.

Situation: The procurement process for indirect materials at the Spanish auto-maker's Vitoria plant was cumbersome. For every requisition, employees completed a form, obtained their manager's approval, asked the controlling department to check account assignment, then handed it over to the purchasing department. No wonder they often bypassed this route. Maverick buying was rife. The result: the plant purchased nonproduction goods and services from 1,500 different suppliers. "We really needed a much leaner process," says head of procurement, finance, controlling and information technology Norbert Litzkow.

Goals: Automation and control were the twin goals of the e-procurement project. The company wanted to use automation to streamline the entire process – from requisition through invoice checking. It also wanted to tighten control by centralizing supplier relationship management and enforcing optimized purchasing strategies: bulk buying and long-term agreements. A further objective was to integrate with the Covisint electronic marketplace, intended as the platform for the majority of the company's procurement transactions.

Process: Mercedes-Benz España opted to implement mySAP E-Procurement, which integrated effortlessly with its existing SAP ERP system. The new, intuitive workflows have reduced the standard procurement process to just one or two steps. The solution's integrated analytics reveal purchasing trends and behaviors, forming an ideal basis for effective procurement strategies. And it provides direct links to online business-to-business (B2B) exchanges.

Results: The number of suppliers has plummeted to around 200 – a far more manageable figure. The smooth interplay between back-office and e-procurement functions has cut purchasing lead times. Reduced routine work allows purchasing staff to concentrate on more strategic tasks like assessing suppliers and negotiating long-term agreements. Mercedes-Benz España plans to use online auctions to reduce the time and resources needed for contract negotiation.

The project is expected to yield a big return on investment. "Mid- to long-term, electronic procurement will save us \$1.5 to \$3 million a year," predicts Litzkow.

Learn more at www.lothair.com

Hurst Boiler Turns Up the Heat on a Hull of an Idea

Company: Hurst Boiler & Welding Co. of Coolidge, GA, manufactures wood, gas, coal, oil-fired steam, and hot water boilers for a variety of industries.

Situation: The Bolivian government was looking for an efficient way to produce electricity for several villages when engineers realized they could create fuel by burning the hulls of Brazil nuts. But to do it, they needed new boilers.

Goal: The government wanted to conserve the nut hulls, which are usually discarded in nearby rivers, as a natural source of energy. A waste-fired system would not only slash the cost of dumping the hulls, it would eliminate the need to drag hull-clogged rivers periodically to keep them flowing.

Process/Tools: Hurst Boiler gained \$1.5 million in new business when the Bolivian government found them on www.ThomasRegister.com. The company broke into the international market about three years ago, and most of its international business since then has come through the Thomas Register Web site. Hurst has also expanded its business domestically by adding CAD drawings of its product line to Thomas Register's PlantSpec® CD-ROM. This CD allows potential customers to easily import CAD drawings directly into blueprints.

Results: Vice President of Sales Jeff Hurst sums it up: "Within our first six months of being on the Internet with Thomas Register, we made over \$6 million in sales. I don't think we could ask for a better result."

In addition to supplying China and the entire Pacific Rim, Hurst Boiler, with customers throughout the U.S. and Canada, is one of the fastest growing boiler companies in America. "We give a lot of credit to Thomas Register," says Jeff Hurst. "It's helped us get into many new markets... and get a leg up on our competitors."

HERE ARE TWO UPCOMING SECTIONS OF RELATED INTEREST:

"Supply Chain Visibility and Collaboration: The Results Are Beginning to Show" a logistics special advertising section appearing in the October 8 issue.

"Industrial & Economic Development: The Strategic Emergence of Location" a corporate location special advertising section appearing in the December 17 issue.

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> Electronic administration frees time for high-value activities. "By automating and distributing the transaction processing into the hands of employees," says Paul Box of Compaq, "we freed up our procurement team to do more value-added work.... We began realizing savings as soon as the first order was processed through the system."

"Within our first six months of being on the Internet with Thomas Register, we made over \$6 million in sales."

— Jeff Hurst
Vice President of Sales
Hurst Boiler & Welding Co.

Reverse auctions are a powerful negotiating tool allowing multiple sellers to bid and sell to individual buyers, hence greatly increasing the competitive landscape and improving purchase price for buyers. DuPont uses reverse auctions on a selective basis, "as a tool to drive purchase costs down to the lowest possible price," states Irrthum.

Sustaining the Gain

One of the most frequently asked questions by executives with regard to purchasing is: What is the magnitude of

savings potential, and can purchases continue to deliver additional savings after year? The answer is that the application of best practices will typically deliver 10 to 20 percent savings or more and, the savings can continue to follow deal after deal.

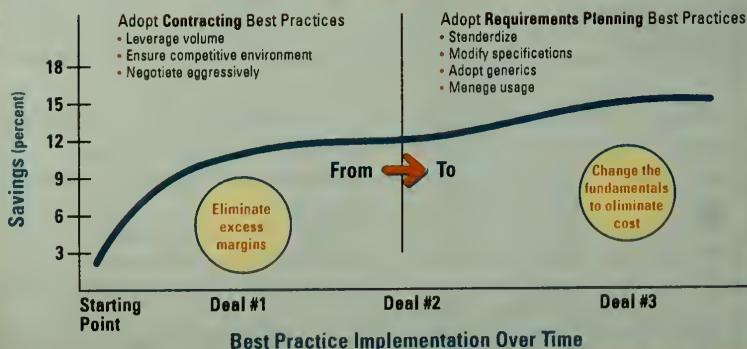
Continuous cost elimination programs that create savings throughout the life of the relationship with the supplier are essential. Eastman Kodak Company's SOLID (Supply Online Idea Database) system encourages its suppliers to submit ideas. "We are trying to eliminate barriers to change," states Timothy Smith, Worldwide Purchasing Strategy Manager. "Of the 2,900 ideas so far submitted have already resulted in \$119 million in savings!," echoes Richard S. Morabito, Purchasing Chief.

Fleet Bank is a firm believer in the concept of sustained cost reduction. Hays states that "strategic sourcing is not considered successful unless the cost reduction and organizational purchasing efficiency can be sustained and institutionalized over the long term."

The Journey Continues

The purpose of this article is to whet the appetite. The sources of best practices are abundant. Smart-Purchasing.com provides a comprehensive online guide to purchasing best practices. In summary, "There is always more savings. You just have to look, ask, and act." ■

Generalized Relationship Between Implementation of Best Practices and Savings



Source: Novartis

extraordinary



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LEARNING TO
FLY AND KIDS
TRAVELING
ALONE

BusinessWeek Lifestyle



Up, Up, and Away

Our man finds it easier to learn to fly than you may think

BY SPENCER E. ANTE

Fear. That's what I expected to feel during my first flying lesson in a single-engine propeller airplane. But taxiing down the narrow airstrip of Lincoln Park Airport in Morris County, N.J., sitting in the left front seat of a Cessna 172 Skyhawk SP, I wasn't scared. Something about flying a plane really focuses the mind. I push in the throttle and my instructor, Nancy Ahlers, steers us down the runway. We quickly accelerate to 65 mph, Nancy pulls back on the yoke ever so slightly, and we lift off into the sky. Yeha!

Tens of thousands of new pilots are experiencing the same thrill this year. After shunning the friendly skies for the past decade, Americans have renewed their love affair with flying private airplanes. Last year, the Federal Aviation Administration (FAA) issued 106,100 student pilot certificates, an increase of 9% over 1999. Most of the licenses went to middle-age men taking up flying as a new hobby, followed by women hobbists and young adults scouting career opportunities.

Be A Pilot (www.beapilot.com), founded in 1997 by companies in the aviation industry, has sparked a lot of interest in flying. Funded by \$2 million in contributions, the nonprofit program of-

fers introductory flight lessons for \$49, half typical price. Last year, more than 35,000 people signed up, the busiest year on record. And registrations are up 11% through the first quarter this year. "Call it a comeback after a 15-year recession in our business," says Drew Steke, CEO of the Be a Pilot program. Until the mid-1990s, product liability lawsuits nearly wiped out the general aviation industry, and manufacturers such as Cessna stopped making planes. But after Congress passed a law in 1994 limiting manufacturers' liability, the industry has slowly come back to life.

Learning how to fly is cheaper and easier than you might think. To get a private pilot's license, the FAA requires students to take 40 hours of training—20 hours of flight instruction and 20 hours of solo flying. But most students average 50 to 60 hours by the time they take the test. Instructors charge \$25 to \$50 an hour. Plus, you'll have to rent a plane. All told, it costs \$3,000



PREFLIGHT

N: to \$5,000 to earn the basic license. From there, you can work to attain higher levels such as an instrument rating, which takes another 40 hours of training, and allows you to fly in bad weather and through clouds.

Private pilots are evenly divided between those who own and those who rent. The Cessna 441, with four seats and a range of 500 miles, costs \$170,000 new, but most starter pilots buy used planes for \$20,000 to \$75,000. Rental rates usually run \$60 to \$100 an hour for a four-seat aircraft and \$50 an hour for a two-seater, with a minimum of two hours on weekdays and one or four hours on weekends.

Still scared? Flying small planes is safer than you might think. The accident rate per 100,000 hours flown in general aviation planes—that excludes commercial airline and military incidents—declined by 45% since 1982, according to the National Transportation Safety Board. Out of 31 million flight hours last year, there were 1,835 accidents, 341 of which involved fatalities. Industry experts attribute the increased safety to improvements in training, aircraft, and navigation technology.

ACROBATICS? "I'm hooked," says Nancy Bandy, of Louisville, Ky. Bandy, who co-owns an advising agency and travels a lot for business, decided to take flying lessons after completing a four-day road trip a few years ago. She started training in July, 1998, and took only four months to get her private license. She now flies three times a week, zipping around to St. Louis, Springfield, Ill., and Indianapolis to meet with clients. She uses her own plane, a four-seat, fully loaded Cessna 441 Mooney 252TSE, which she bought last year for \$185,000. "It seems like such a big thing, but once you take it one step at a time, it brings a sense of accomplishment," says Bandy, who plans to learn how to do aerial acrobatics one day. "I probably won't take it that far. But after my four-hour lesson, I see why people catch the flying bug. Our mission is to fly the Hudson River Corridor, a designated flight zone and mecca for

pilots that runs 24 miles, from the Tappan Zee Bridge near Tarrytown, N.Y., to the Verrazano Narrows Bridge, which connects Brooklyn and Staten Island. It's a beautiful, sunny day, with good visibility.

On the ground, we conduct a preflight check. I help inspect dozens of things, such as the wing's nuts and bolts and the fuel quality. Experienced pilots run a flight-check in 15 or 20 minutes, but we take 45 minutes since it is my first lesson. We begin our ascent. Nancy takes the plane up to 2,500 feet, lines up the nose with a building in the distance, and lets me take the reins. I gently grab the yoke, turning it to the right while also pressing down on the right floor pedal to accentuate the turn. If I make a mistake, Nancy can use her own yoke to take control of the plane. I fly us all the way to the Hudson, zigzagging back and forth to get a feel for the plane. I see a helicopter and hum Wagner's *Ride of the Valkyries*.

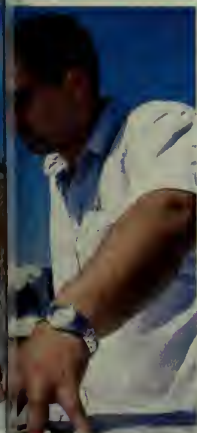
Nancy takes over the plane as we fly into the Corridor. "Hudson River Traffic, this is November 814 Lima Papa," says Nancy, broadcasting our position. "We're at 900 feet over the George Washington Bridge, southbound on the New Jersey side." At this low altitude, Manhattan looks like a city in a giant miniature train set, and everything seems close enough to touch. I spot Yankee Stadium; then Central Park's green swath comes into view. I stare at the tips of the Empire State and Chrysler buildings. I look below and the sun's rays glisten off the Hudson's emerald-green surface. Then a blimp whizzes by us on the other side of the river. "I have never seen that," says Nancy. "That's cool."

Some 30 minutes into the flight, we fly past the Statue of Liberty and head back up the river. It's exhilarating, this flying thing, like riding a motorcycle in the air. Cruising in a light single-engine plane, you are inside the experience, living it, feeling it, rather than viewing it as a detached observer through a tiny portal. When we land in New Jersey, I feel disoriented, exhausted, and a bit queasy. At that moment, the thrill is gone. But I know I'll want to taste it again. ■

Accident rates for small planes have declined by 45% since 1982, and most experts attribute the drop to safer aircraft and better training for pilots

Flying Lessons

40 HOURS IN THE AIR CAN EARN A LICENSE



Pilot plots a course



AIRBORNE: The instructor can take control at any moment



PROOF: Ante's certificate

Thumb-Sucker at 37,000 Feet

Airlines are paying closer heed to kids who fly alone

BY AIXA M.
PASCUAL

When Tiü Lukk booked her 9- and 12-year-old sons on a flight from their Los Angeles home to a camp in Minnesota last summer, she paid the \$25-per-child fee that American Airlines charges to keep an eye on minors traveling by themselves. But when she called the camp, the boys hadn't arrived. After nearly six hours—during which no one at American could say where they were—her sons phoned to say they had arrived safely. (They missed a connecting flight in Dallas and were put on a later plane.) American sent her an apology and travel vouchers after she wrote an angry letter. When Lukk's sons flew this year, she didn't register them as unaccompanied minors and instructed them to call her collect at every stop. "At least I trust them to do what I told them to do and call me," she says.

Most of the hundreds of thousands of children who fly alone in the U.S. each year do so uneventfully. But recent snafus show how badly things can go wrong. On July 14, America West Airlines put an 11-year-old girl on the wrong connecting flight and sent her crisscrossing the country for 12 hours before getting her to the right destination—at 7 a.m. the next day. The airline says a communication breakdown caused the mistake, which was "inexcusable."

CHILDREN FLYING SOLO

- Don't put your kid on a plane alone if he or she hasn't flown before.
- Use the "mall test" to make sure your young traveler is self-sufficient enough: Can she get to a mall by public transportation, make purchases, eat, find the bathroom, and then make her way home?
- Let your child know what to expect on the trip, such as a time change and length of the flight.
- Make sure your child carries identification and a copy of the itinerary in a safe place, along with all pertinent contact phone numbers.
- Equip your child with a prepaid calling card and a cell phone, if possible.
- Plan to be at a number where your child or the airline can reach you immediately for the duration of the trip.
- Avoid routes that require a connecting flight.

The government offers little help. The Department of Transportation doesn't require lines to report on lost children. "There aren't regulations," says Mary Schiavo, a former DOT inspector general. Airlines set their own policies, which they usually post on their Web sites.

Virtually all bar children under 5 from traveling alone and require those flying solo to register as unaccompanied minors. Age policies vary, depending on the airline and whether the child is on a direct or connecting flight. Effective September 10, America West is upping the minimum age for connecting flights from 8 to 12, partly because of the July fiasco. The carriers charge a fee for unaccompanied kids—\$30 to \$40 each way for direct flights; \$60 to \$75 for domestic connecting flights—



providing adult supervision until the child is picked up by an individual authorized by the parent.

Kids flying for the first time should do so with an adult, experts say. For those who have flown before, David Stempler, president of Air Travelers Assn., suggests this test: If your child can take public transportation alone to a mall, make a purchase, find the rest room, get back home, she's likely O.K. to fly solo.

Tell your child what to expect: how long the flight will be and if there is a time change. Instruct her never to leave the gate area without anyone but the assigned airline staff. On board, she should direct questions and requests to flight attendants, not adults sitting nearby. Make sure she carries an ID, an itinerary, your phone numbers, and those of the adult meeting her.

Try to avoid connecting flights, even if you or the adult at the other end must drive a more distant airport. And give your child a paid calling card or a cell phone. That way, you don't have to wait for the airline to tell you where your kid is.

MAKE SURE YOUR NEST EGG IS GOLDEN, NOT SCRAMBLED



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NO ARTS, NO CRAFTS, ALL BUSINESS



BY TODDI GUTNER

hers@businessweek.com

At Camp \$tart-UP and others like it, today's young women receive the training to become tomorrow's corporate leaders

The group sat huddled over their copious notes and calculators as they desperately tried to cut \$2,000 from the budget of their hair-care-products company. Perhaps if they nixed the Web site or reduced the product lineup, they might be able to book a profit in their first year of operation.

A high-level business meeting of small-company executives? No. It was 6 of the 22 teenage girls who were spending two weeks in July at Camp \$tart-UP at Dana Hall School in Wellesley, Mass. Instead of canoeing, horseback riding, and roasting marshmallows, these campers, ages 13 to 17, learned business basics, developed business plans, and networked with women entrepreneurs. "I now know what I have to do, and how I need to think if I want to start a business," said 15-year-old Caroline Keating of Medford, Ore., who took the opportunity after our chat to ask me for my business card.

PLANTING A SEED. Inspiring young girls like Keating to pursue their entrepreneurial dreams and build leadership skills is exactly what Camp \$tart-UP and two other residential summer programs, Camp Entrepreneur and Camp CEO, aim to do (table). "We want to plant a seed that these girls can do anything they want," says Valjeanne Estes, the director of Camp \$tart-UP, which is run by Independent Means, a Santa Barbara (Calif.) company that creates educational programs to teach girls financial independence.

Camp \$tart-UP reinforces its classes on business plans, marketing, finance, operations, and social responsibility with presentations and coaching sessions by successful businesswomen. Students learn how great business ideas often come from personal experience. Dina Chu, co-founder of Boston-based New Basics, which patented a brush-in hair color application, told of how she invented the process because she didn't like what was available.

Under the guidance of a counselor, usually experienced businesswoman, the campers are divided by age into four groups. They take classroom material and apply it to their own business plans. At the end of camp, each group presents its plan in front of businesspeople, such as bankers from FleetBoston Financial. There are also field trips to companies such as Cathine Hinds, a cosmetics maker, and sightseeing spots around Boston. Camp \$tart-UP is also offered at four other locations nationwide: Athenian School in Danville, Calif.; Skidmore College in Saratoga Springs, N.Y.; Vassar College in Poughkeepsie, N.Y.; and Camp Austin Chisholm, Minn. The Wellesley camp ran \$1,000 but as many as 65% of the campers were scholarships paid for by FleetBoston and



DOWN TO CASES: A planning session at Camp \$tart-UP

Ladies Professional Golf Assn., among others.

The day I visited, it was crunch time—days away from the presentations. The executives at Mane St. Scents, maker of shampoo and other hair products in 34 scents, were trying to balance their budget. At Custom Design, manufacturer of custom-made jeans, skirts, swimsuits, the leaders had to consider relocating their facilities when they discovered that renting their current Boston operation would cost more than their estimated profit for the first year. Those in charge of Athletic Woman, a producer of women's tennis and golf clothes, were deciding whether to outsource their operations to Mexico. And the people who ran Jibba Jabba, a corporation music store and bistro, were researching the average price per square foot for a space in New York City and pricing bar stools on eBay.

"Starting a business is a lot of hard work, I've learned not to get discouraged or give up and that I can do it," says Valeria Shipp, a year-old from Euclid, Ohio. No doubt, when Shipp returns to school this fall, her essay "What I Did On My Summer Vacation" is going to read a little different from her peers'.

Camp Out, Cash In

PROGRAM/SPONSOR	DESCRIPTION
CAMP CEO Girl Scouts Arizona www.acpgsc.org/campceo 800 354-6133	One-week residential camp for 9th to 12th graders; emphasizes entrepreneurial and leadership skills
CAMP ENTREPRENEUR National Education Center For Women in Business www.e-magnify.com 724 830-4625	One-week overnight camp for 14- to 17-year-olds; learn business and entrepreneurial skills
CAMP \$TART-UP Independent Means www.independentmeans.com 805 965-0475	Two-week residential program for 13- to 19-year-olds; start a company and write a business plan

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Robbins, Vic Conant, Brian Tracy, Tom Hopkins, Denis Waitley and dozens of other business building gurus.

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And Investor's Business Daily wrote, "*He knows how to get maximum results from minimum efforts*." USA Today commented, "*Just because the economy is slowing, doesn't mean your business has to [if he helps you].*"

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the company ten times more profit from their distribution channel than they'd made from their main product itself.

- A software company generated 800% more orders by using one of their ideas.
- A medical industry company cut personnel 37% and tripled business at the same time.
- A Mercedes dealer tripled profit on a \$300 million dealership.

Besides being recognized as an international marketing genius, Jay Abraham has also been called the "World's Super Consultant," advising such notable superstars as Tony

CONTINENTAL'S IPO: DON'T RUSH IN



BY ROBERT BARKER

rb@businessweek.com

As part of its spin-off of ExpressJet, the parent airline is planning a stock offering. While the risks look limited, so does the potential

Investing in airlines, as a hedge-fund investor once warned me, demands elaborate precautions: nothing short of garlic necklaces and voodoo incantations. So susceptible are airlines to every gust—rising fuel prices, slowing economic growth, stormy labor relations, and rotten weather—that the stocks seem to suit only the brave or the foolish.

Now, Continental Airlines is getting ready to offer investors a new way to prove themselves heroes or fools. In September, Continental aims to sell stock to the public in a unit called ExpressJet Holdings. ExpressJet runs Continental's fast-growing feeder airline, Continental Express, the nation's No. 2 regional—with routes to 113 cities, from Quebec to Ixtapa, Mexico. If all goes according to plan, six months or so after the deal, Continental will hand out the rest of its ExpressJet stock to its own stockholders, and ExpressJet will be on its own.

As Continental and underwriter Salomon Smith Barney have structured the spin-off, ExpressJet will be insulated from some of the vagaries of the airline biz. By mid-August, Continental (whose execs aren't commenting) had not estimated its price for the shares or specified how much of ExpressJet it hopes to sell. Yet from a look at Continental's preliminary securities filing, I think anyone interested in ExpressJet stock had better keep the garlic handy.

UP HIGH. Not that I foresee a crash. Revenue last year rose 30%, to \$844 million. In this year's first quarter, it grew 33%. If Continental had set up and done the accounting for ExpressJet last year the way it does now, the regional would have posted an \$84 million operating profit. With scores of new jets ordered for the next three years (chart) and with Continental having contracted to buy all of that capacity, ExpressJet has a good line on near-term growth. The contract also calls for Continental, not ExpressJet, to bear such risks as light loads, low fares, and high fuel prices.

So what's wrong? First, the fleet-use contract targets an operating profit margin for ExpressJet that financial statements indicate is 10%. Whether that's high, low, or just right, I don't know. The point is, at least through 2004, it won't vary much. If ExpressJet realizes a slimmer margin, Continental will "true up," or supplement, its payments to ExpressJet. If ExpressJet's margin exceeds the target, it will have to refund some fees. So, just as ExpressJet's



FAST-GROWING: ExpressJet is the nation's No. 2 feeder

risks are limited, so is its potential. When ExpressJet will price its stock high, compared with expected earnings, remains to be seen. don't count on getting it at a discount.

The bigger worry facing investors is ExpressJet's continuing dependence on Continental. Yes, Continental aims to spin off its entire stake in ExpressJet. But as its largest customer, Continental will still wield huge influence through seat on the board and a raft of contractual conditions, including a "most favored nation" clause.

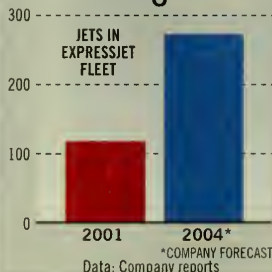
That gives Continental the right to enjoy any concessions ExpressJet might offer to attract business from another major line. Yet at the same time, Continental is free to license Continental Express name to other regionals. ExpressJet can probably forget about being taken over at a nice premium. As long as Continental is ExpressJet's largest customer, change in control would slash payments on its flights

til ExpressJet's profit margin vanishes.

Just how much ExpressJet hopes to raise in the deal is unknown, but by now you can guess who gets the proceeds: Continental. ExpressJet is saddled with a debt to Continental of \$150 million. Whatever ExpressJet raises in the public offering will go to pay that off. In addition, Continental is using the deal to lighten its hefty debt load. It plans to give ExpressJet stock to its banker, Salomon, in exchange for taking \$150 million in debt off its hands. Salomon then would resell those shares in the market.

It's hard to look at this deal without concluding that the chief beneficiary will be Continental. Investing in Continental may suit the bill. Chances are, ExpressJet's IPO is just for form's sake.

Taking Off



BusinessWeek online

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SHINING ECHOSTAR

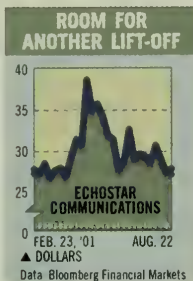


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EchoStar, growing
in satellite TV,
buy a rival.
al mortgages
help Hispanics
the mainland.
Medicare rules
just the tonic
abCare needs

Last October, Inside Wall Street reported that EchoStar Communications might surface as a suitor for Hughes Electronics' DirecTV, the nation's largest satellite-television broadcaster, now owned by General Motors. Indeed, EchoStar, the No. 2 player in satellite-to-home services, came through on Aug. 5 with a stock-swap offer valued at about \$30 billion. "The synergies that would come from this combination are the best you can get," says analyst Vijay Jayant of Morgan Stanley, who pegs EchoStar at 50. It currently trades at 28.

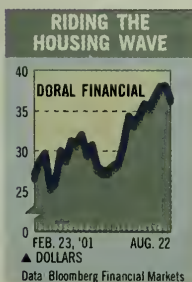
With or without Hughes, EchoStar enthusiasts say it's a gem. Sure, the two companies combined would have 16 million subscribers and go head-to-head with the nation's top cable operators—if, that is, EchoStar's bid beats out a competing offer by Rupert Murdoch's News Corp. and then gets the nod from regulators. But EchoStar is already adding subscribers faster than its rivals. In the second quarter, it surprised analysts by reporting first-ever operating profits of \$64 million, plus a net profit of \$2 million. Deryck Lampe, portfolio manager of Stein Roe & Farnam, says the Littleton (Colo.) outfit will generate \$380 million in cash flow this year and will top \$2.5 billion by 2004. "What is truly impressive is the very limited investment required to generate this level of growth," says Lampe, who first bought the stock in February and now has 3 million shares, purchased at an average cost of 27. He expects the stock to be "north of 50" by this time next year.



DORAL: TO NEW YORK FROM PUERTO RICO

Doral Financial, Puerto Rico's largest mortgage originator, knows how to talk the talk—in Spanish. Doral, which does 50% of the island's home financing, is expanding on the mainland, angling for a bigger slice of the Hispanic market. Its New York-based thrift, Doral Bank FSB, has just opened a second office, in Washington Heights, and has plans for one in Astoria. The branches are targeting New York's huge Puerto Rican community. They'll have bilingual reps and extended weekend hours to accommodate working families. "The Hispanic market is underserved by city banks, and there's some distrust in the community," says Mark Alpert of Deutsche Bank Alex. Brown.

"But given Doral's brand recognition,



they may be able to crack the market here."

Doral, which also operates 27 commercial banking offices in Puerto Rico and one in Miami, has enjoyed three decades of consistent profitability, low credit risk, and enormous competitive advantages, says Alpert. Its stock has already surged 60% so far this year, hitting a 52-week high on Aug. 14. But Alpert, whose firm oversaw a secondary offering in July of 4.4 million shares at \$32.50 each, says it has more room to run. His target is 45. "It's still undervalued," he says, noting that Doral's return on equity is 23%, vs. 14.9% for most banks. In July, Gary Gordon of UBS Warburg raised his price target and earnings estimates for Doral. He estimates 2001 earnings per share will be \$2.60, compared with First Call Consensus estimates of \$2.58. His 2002 estimate of \$3.20 also beats the consensus figure of \$3.07.

REHABCARE IS SET FOR A BOOSTER SHOT

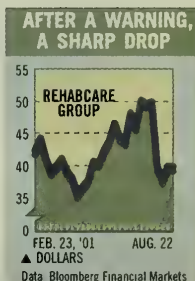
Hospitals and nursing homes are coming up empty-handed in their search for good help. The nursing shortage—expected to become more acute as the population ages—has boosted business for RehabCare Group, a national provider of temporary health-care staff. The St. Louis company has grown through "deft acquisitions" in 1998 and 1999, according to J.P. Morgan Chase's Matthew Ripperger. He started covering RehabCare on Aug. 2, with a "long-term buy" rating and a 57 price target. The stock now trades at 40.

A revamped system for Medicare reimbursements next year could provide a new catalyst for growth. The new system will cap reimbursements to hospitals and nursing homes, putting a squeeze on facilities to cut costs. RehabCare's inpatient and out-patient program management division stands to gain.

Still, Wall Street has been hard on the stock, which is down 23% so far this year. While the company reported a 41% rise in second-quarter profits, or 43¢ per share, over the past year, it warned on July 31 that future 2001 earnings will be at the low end of consensus estimates.

The stock fell 12% that day, just two weeks after hitting a 52-week peak. Judith Scott of investment firm Robert W. Baird, however, reiterated her "strong buy" rating and says the pullback is a buying opportunity. Her target is 53.

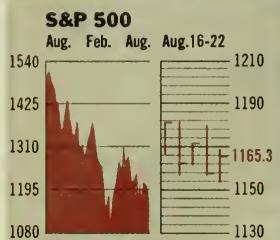
Gene Marcial is on vacation.



BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:20 p.m. EST on CNNfn's *The Money Gang*.

Stocks



COMMENTARY

Like joggers running in place at an intersection, stocks are bouncing up and down waiting for the green light of corporate profits. Encouraging comments from General Motors, Intuit, and semiconductor equipment makers lifted the market Aug. 22. But that did not make up for fears Fed interest rate cuts aren't working. For the week, the S&P 500 lost 1.1%, the Nasdaq 3.1%.

Data: Bloomberg Financial Markets
Bridge Information Systems, Inc.

U.S. MARKETS	Aug. 22	% change		
		Week	Year to date	Last 12 months
S&P 500	1165.3	-1.1	-11.7	-22.2
Dow Jones Industrials	10,276.9	-0.7	-4.7	-7.7
Nasdaq Composite	1860.0	-3.1	-24.7	-53.0
S&P MidCap 400	498.5	-0.8	-3.5	-4.8
S&P SmallCap 600	226.5	-0.5	3.1	5.5
Wilshire 5000	10,784.9	-1.2	-11.4	-22.8

SECTORS

	Aug. 22	Week	Year to date	Last 12 months
BusinessWeek 50*	783.5	-1.3	-19.2	-38.8
BusinessWeek Info Tech 100**	391.3	-5.2	-30.8	-58.6
S&P/BARRA Growth	584.7	-1.0	-15.0	-34.9
S&P/BARRA Value	581.1	-1.2	-8.7	-7.2
S&P Energy	860.4	-1.7	-7.7	-5.5
S&P Financials	152.2	-1.4	-7.6	-2.4
S&P REIT	97.8	1.6	11.2	13.9
S&P Transportation	671.0	-1.9	-3.8	6.7
S&P Utilities	280.0	0.9	-20.2	-8.7
GST Internet	98.0	-3.1	-46.1	-77.7
PSE Technology	643.1	-2.2	-21.0	-42.0

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Household Products	8.1	Engineering & Constr. 73.5
Drug Chains	7.4	Savings & Loans 66.6
Gold Mining	5.9	Toys 66.0
Foods	5.9	Hospital Management 62.7
Specialty Printing	5.6	Pollution Control 61.4

GLOBAL MARKETS	Aug. 22	Week	Year to date	% change
S&P Euro Plus (U.S. Dollar)	1120.9	-2.1	-21.0	
London (FT-SE 100)	5408.7	-1.0	-13.0	
Paris (CAC 40)	4812.1	-2.5	-18.0	
Frankfurt (DAX)	5220.2	-4.3	-18.0	
Tokyo (NIKKEI 225)	11,396.4	-3.1	-17.0	
Hong Kong (Hang Seng)	11,188.6	-7.9	-29.0	
Toronto (TSE 300)	7538.6	0.1	-19.0	
Mexico City (IPC)	6333.1	-3.2	12.0	

FUNDAMENTALS

	Aug. 21	Wk. ago
S&P 500 Dividend Yield	1.35%	1.31%
S&P 500 P/E Ratio (Trailing 12 mos.)	32.4	32.9
S&P 500 P/E Ratio (Next 12 mos.)*	20.8	21.2
First Call Earnings Revision*	-4.80%	-5.91%

*First Call Corp.

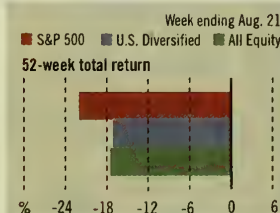
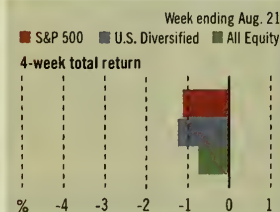
TECHNICAL INDICATORS

	Aug. 21	Wk. ago
S&P 500 200-day average	1262.4	1268.5
Stocks above 200-day average	62.0%	63.0%
Options: Put/call ratio	0.79	0.72
Insiders: Vickers Sell/buy ratio	3.01	3.20

WORST-PERFORMING GROUPS

	Last month %	Last 12 months %
Specialty Appar. Retailers	-21.2	Communications Equ. 12.0
Homebuilding	-18.5	Semiconductors 12.0
Automobiles	-17.2	Computer Systems 12.0
Dil & Gss Drilling	-16.4	Instrumentation 12.0
Computer Software	-12.0	Dil & Gss Drilling 12.0

Mutual Funds



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-week total return	%	52-week total return	%
Leaders		Leaders	
Real Estate	5.3	Real Estate	17.2
Precious Metals	2.6	Small-cap Value	16.3
Natural Resources	2.1	Mid-cap Value	14.9
Europe	2.0	Financial	13.3
Laggards		Laggards	
Technology	-7.0	Technology	-58.8
Communications	-6.3	Communications	-53.6
Mid-cap Growth	-3.4	Japan	-35.8
Latin America	-3.1	Large-cap Growth	-35.7

EQUITY FUNDS

4-week total return	%	52-week total return	%
Leaders		Leaders	
Potomac Internet Short	15.3	Potomac Internet Short	200.1
iShares MSCI Taiwan Index	14.3	Rydex Arkotus Investor	95.9
Matthews Korea	13.6	CGM Focus	86.0
iShares MSCI S. Korea Index	10.1	Schroder Ultra	79.9
Laggards		Laggards	
ING Internet A	-15.9	Berkshire Focus	-84.6
Berkshire Focus	-15.8	Berkshire Technology	-84.6
Berkshire Technology	-15.8	Jacob Internet	-82.8
J.P. Morgan H&Q Gl. Tech. A	-15.4	Potomac Internet Plus	-82.5

Interest Rates

KEY RATES

	Aug. 22	Week ago
MONEY MARKET FUNDS	3.40%	3.45%
90-DAY TREASURY BILLS	3.38	3.43
1-YEAR TREASURY BILLS	3.44	3.47
10-YEAR TREASURY NOTES	4.91	5.00
30-YEAR TREASURY BONDS	5.44	5.52
30-YEAR FIXED MORTGAGE†	6.93	6.91

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 31% federal tax rate.

	10-yr. bond	3-yr. bond
GENERAL OBLIGATIONS	4.17%	
TAXABLE EQUIVALENT	6.04	
INSURED REVENUE BONDS	4.28	
TAXABLE EQUIVALENT	6.20	

THE WEEK AHEAD

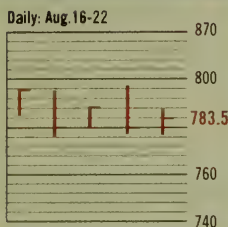
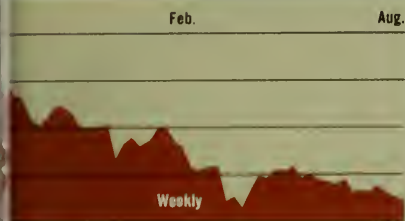
EXISTING HOME SALES Monday, Aug. 27, 10 a.m. EDT ▶ Sales of existing homes probably slipped to an annual rate of 5.25 million in July, from 5.33 million in June. That's according to the median forecast of economists surveyed by Standard & Poor's MMS, a division of The McGraw-Hill Companies.

CONSUMER CONFIDENCE Tuesday, Aug. 28, 10 a.m. EDT ▶ The Conference Board's August index of consumer confidence likely slipped to 116, from 116.5 in July.

GROSS DOMESTIC PRODUCT (REVISION) Wednesday, Aug. 29, 8:30 a.m. EDT ▶ The Commerce Dept.'s second look at second-quarter economic growth is expected to show real GDP grew at just a 0.1% annual rate, down from the advance estimate of 0.7%. A further drop in inventories and a decline in exports are expected to bring the economy to near-zero growth. Third-quarter real GDP is forecast to rebound to an annual rate of 1.5%. Aftertax corporate profits likely fell 9.3% in the second quarter.

PERSONAL INCOME Thursday, Aug. 30, 8:30 a.m. EDT ▶ Personal income grew by 0.3% in July, after increasing 0.3% in June. Consumer spending in July probably grew by a smaller 0.1% after rising 0.4% in June. Consumers beginning to spend less and save in response to growing job jitters.

FACTORY INVENTORIES Friday, Aug. 31, 10 a.m. EDT ▶ Manufacturing inventories likely fell for a sixth straight month, 0.2% in July, after a 0.7% drop in

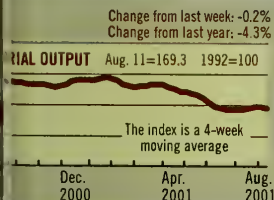


Week 50 index of growth stocks fell 1.3% last week—good compared with Nasdaq's 3.1% loss. Merck climbed 3.4% on its success substituting generic fluoxetine for Prozac. The big loser, Atlanta, maker of digital set-top boxes, dropped 15.7% after retracting earnings guidance and citing restructuring. Internet equipment maker Tellabs lost 10.4% due to lower capital spending.

COMPANY PERFORMANCE

Company	% change		Rank	Company	% change	
	Week	Since 3/1/01			Week	Since 3/1/01
International	-0.4	-3.7	26	Verizon Communications	-0.7	8.5
Petroleum	-8.9	-14.3	27	Citigroup	-3.3	-3.4
	-0.5	-30.8	28	Sun Microsystems	-7.4	-31.8
	-2.5	-11.3	29	Merck	3.4	-10.7
Materials	0.4	-3.2	30	El Paso	5.7	-30.9
Financial	-5.7	-11.9	31	Altera	-0.7	13.3
Petroleum	-3.6	15.3	32	Marsh & McLennan	-1.6	-7.6
	-7.0	-15.1	33	Household International	-3.6	12.1
ee	-3.8	-5.6	34	Chevron	-1.1	5.9
	-2.5	-31.5	35	SBC Communications	-2.6	-7.1
Brothers Holdings	-1.4	-4.8	36	Mercury Interactive	-2.1	-47.2
	-3.7	-63.9	37	AOL Time Warner	-0.5	-10.2
	-3.3	-37.5	38	Washington Mutual	-3.0	20.9
Laboratories	-6.3	11.1	39	General Dynamics	-1.8	19.8
Financial	2.7	-7.0	40	Comcast	1.0	-13.5
Technology	2.2	3.8	41	Morgan Stanley Dean Witter	-2.7	-15.9
	3.3	-6.0	42	Tellabs	-10.4	-68.6
Hess	-2.8	5.9	43	Exxon Mobil	-1.9	0.0
ergy	3.9	-5.7	44	Scientific-Atlanta	-15.7	-53.9
Communications	-7.4	-60.2	45	U.S. Bancorp	1.0	7.5
Financial	-5.3	8.0	46	Paychex	-0.7	-2.1
Petroleum	-2.7	7.8	47	Merrill Lynch	-2.7	-14.4
Services	1.1	15.6	48	Bed Bath & Beyond	-3.0	13.6
Resources	-6.9	-22.8	49	Texas Instruments	0.7	3.9
Health	1.6	12.5	50	Teradyne	0.5	1.6

Production Index



Production index fell for the first time in two weeks. The calculation of the four-week moving average tumbled to 167.7 from 169. On a seasonal basis, auto and truck assemblies drove the index down, while rail-freight traffic, coal, and steel declined. Electric power was up sharply, and the Midwest experienced a week-long shutdown of oil refining and lumber were also down.

For more information on the production index, visit www.businessweek.com. Copyright 2001 by The McGraw-Hill Companies.

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BW 50 Track the index and the companies in it all day long. Plus: our exclusive Info Tech 100 index.

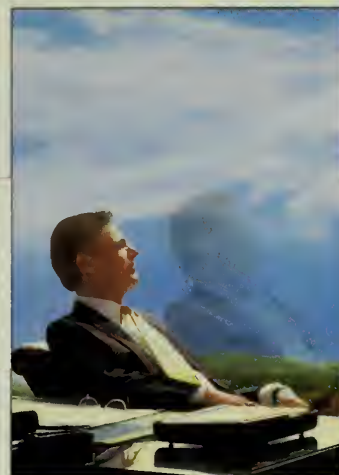
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THE FED: A NEW BUBBLE IN THE MAKING?

Call it the double bubble. A housing bubble may be developing—right behind the Nasdaq bubble. Although overall stock prices are down 12% and the Nasdaq is off 25% since the start of 2001, average house prices are rising at an annual rate of 8%. In fact, falling equities have led many well-heeled investors to shift money into residential real estate. Robert J. Shiller, author of *Irrational Exuberance*, which predicted the Nasdaq crash a year before it happened, now warns that a psychological frenzy not unlike tech mania is gripping housing. It appears that the Federal Reserve's dramatic rate-cutting campaign to revive the economy may be overheating housing. Perhaps the Fed should take a time-out after the latest cut in interest rates to cool off housing—before it's too late. For the vast majority of families, a house is a more important investment than stocks. It could take a far smaller percentage drop in property prices to deliver an equally devastating blow to the economy. Some key financial institutions could be badly hurt (page 34).

The bursting of the Nasdaq bubble hit Corporate America right between the eyes. A housing crash would slam consumers. Consumer spending has been sustaining the economy ever since technology and manufacturing companies began to pare back their capital investments. Many families are carrying a heavy load of debt to finance that spending. They

count the value of their house as real savings to support that debt. If a big chunk of that value disappears, consumer spending could easily dry up. For those families that have already been stung with massive equity losses in their mutual funds and 401(k)s, this second hit from a housing drop could be financially catastrophic.

Lower interest rates could also send the dollar reeling. The greenback is already softening against the euro and the yen. This is good for the exports and profits of multinationals. But a sliding currency often becomes a plummeting one. A rapidly falling dollar could fast undermine the stock market and future capital investment by drying up foreign capital flows.

Most important, lower short-term interest rates can't generate the one thing essential to rekindling growth: corporate investment. Tech and manufacturing must work through their inventories before they increase production. Telecoms must consolidate before they can buy new high-tech gear. Companies must cut costs and recover from their profits recession before they hire again. Lower rates can't help much here.

The Conference Board's index of leading indicators rose July for a fourth straight month, suggesting that growth could pick up before yearend. This may be a judicious moment for the Fed to just watch and wait. There still may be time to prevent a double bubble.

JAPAN MUST MAKE PEACE WITH ITS PAST

The recent visit by Japanese Prime Minister Junichiro Koizumi to the Yasukuni Shrine, a memorial to the country's war dead and a symbol of Japanese militarism, has riled countries all around the Pacific Rim. Loud protests have been heard from the nations that suffered from Japanese aggression in World War II: China, Malaysia, the Philippines, Singapore, South Korea, and Taiwan. Only one country has remained silent: the U.S. Considering that 14 of Japan's top war criminals honored at Yasukuni were tried under the U.S. occupation led by General Douglas MacArthur, the silence is stranger still.

The Bush Administration is trying to bolster Japan's strategic military role in Asia. That effort, however, is doomed to failure unless Japan comes to terms with its history. This means admitting to the terrible harm it inflicted in World War II, expressing the proper remorse, and providing its own young people with textbooks that offer a factual account of the atrocities of those years. Washington should end its silence and publicly encourage the Koizumi government to begin to guide Japan through a process of facing its wartime past, as Germany did decades ago.

The Bush Administration and especially the Defense Dept. should realize that unless Japan reaches a rapprochement with its neighbors for its past deeds, Asian countries will be

extremely reluctant to accept Japan's regional military leadership anytime soon. "How can we make friends with people who try to forget and ignore the many pains they inflicted on us?" asked President Kim Dae Jung of South Korea, in response to the shrine incident. "How can we deal with them with any degree of trust?"

Koizumi's Yasukuni Shrine visit comes just weeks after South Korea and China lodged a strong protest against new Japanese history textbooks that downplay the forced prostitution of South Korean women during the war and the infamous Rape of Nanking in China, in which 300,000 people perished. A second pilgrimage to the shrine—by Tokyo Governor Shintaro Ishihara, Defense Agency Director General Nakatani, and other members of Koizumi's Cabinet on the 56th anniversary of Japan's surrender—further incensed Korea and other nations in Asia. It drove home the notion that the Koizumi government has close ties to extreme Japanese nationalists.

It may be true that no nation handles its historic misdeeds very well. But Japan has done a spectacularly poor job. Its aspirations to world leadership are undermined by its refusal to acknowledge the dark side of its history. America does neither Japan nor itself a favor by ignoring so obvious a breach of international civility.



BusinessWeek

SEPTEMBER 10, 2001

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How
Europe is
taking the lead

Chicago's Pitzkers



next
generation

Strategies

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Wall Street's vulture investors
are risking billions to buy up the
wreckage of the economic bust

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FIRE SALE



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A woman in a black suit and white shirt stands on a wide, curved stone staircase. She holds a white sign with red text that reads "COLLABORATE OR DIE". The staircase is made of light-colored stone steps and is flanked by dark, curved walls. The scene is dimly lit, with the woman and her sign being the central focus. Other people are visible in the background, but they are blurred, suggesting movement or a shallow depth of field. The overall mood is serious and dramatic.

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OR
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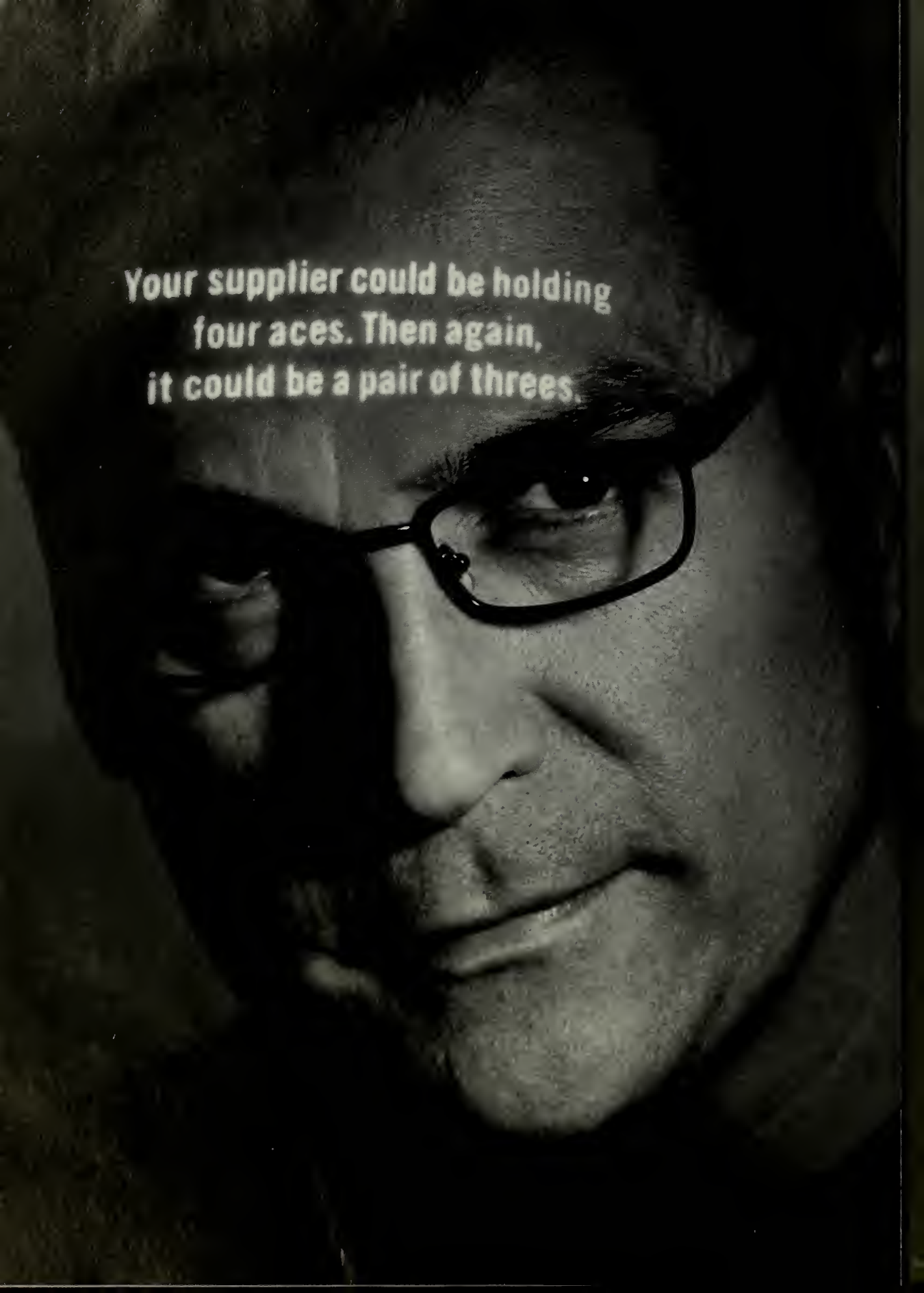
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COVER STORY

THE GREAT AMERICAN FIRE SALE

Meet the vulture capitalists who are snapping up the economy's losers. They're playing a crucial role in paving the way for recovery **page 108**



MENDING FENCES

The Fox-Bush talks will spur a nationwide debate on immigration

page 40

Cover Story

108 THE GREAT AMERICAN FIRE SALE

Wall Street's vultures are buying companies and their assets at bargain prices on an unprecedented scale—never before have so many companies been on the block for so little. Vultures, of course, often get a bad rap, and sometimes it's deserved. But by providing shareholders and creditors with an exit, they allow for an orderly liquidation of assets instead of a financial panic—or a freeze-up of the kind that has kept Japan in gridlock for more than a decade. Here's how they do it

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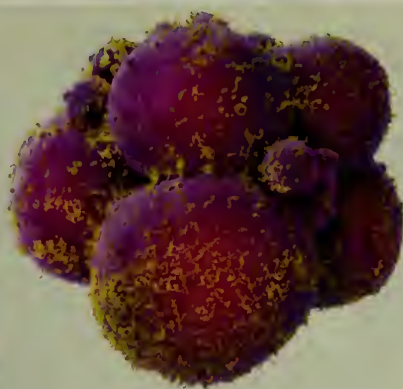
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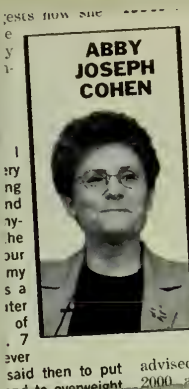
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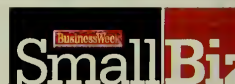
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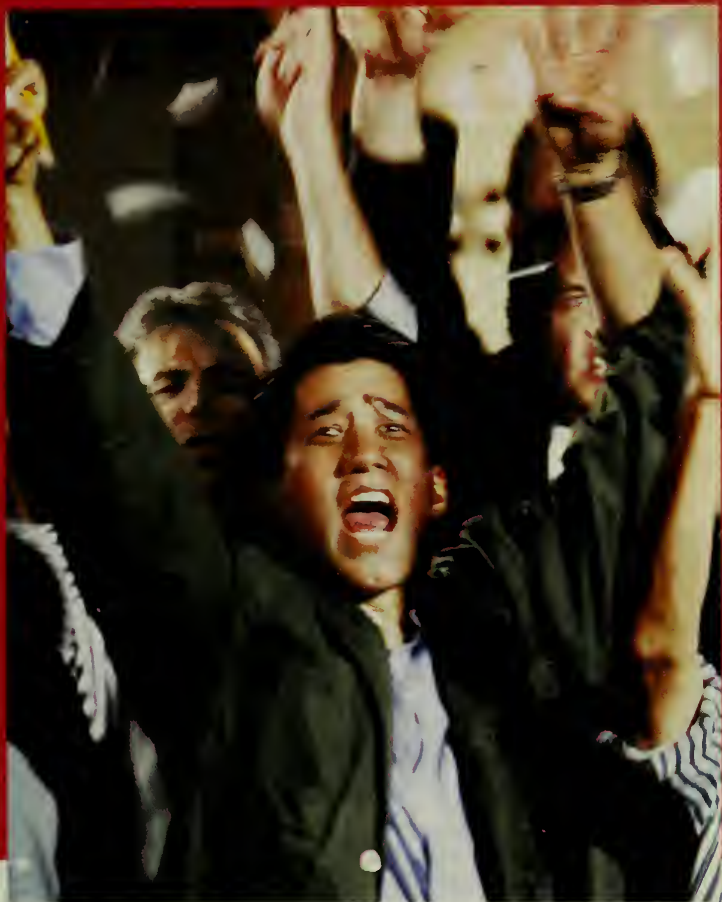
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Up Front

EDITED BY SHERIDAN PRASSO

BUSH WHACKINGS

THINK TWICE ABOUT HAVANA HOLIDAYS

"SEE CUBA BEFORE CASTRO dies." Travel hipsters have been chanting that mantra, spurred on by reports that 75-year-old Fidel has fainted, is in ill health, or can no longer deliver five-hour-long speeches in the blazing sun.



TOURISTS: *G-men are watching*

But just as travel to Cuba is escalating, with tens of thousands of Americans going last year, the Bush Administration is cracking down. Many tourists are canceling trips, and organizations that offer legal excursions under the exempted category of cultural exchanges are getting tougher about whom they'll take. "It's very distressing," says Sandra Levinson, who

runs study trips from her Center for Cuban Studies in New York. "We are self-censoring because it seems the Bush Administration is enforcing the rules much more strictly."

While travel itself is not illegal, U.S. laws prohibit American tourists from spending money there. But starting in May, the Treasury Dept. says it sent more than 400 letters to tourists telling them they'd been caught. The Clinton Administration sent 188 letters in 2000, with fines averaging \$3,000. This year, fines are averaging \$7,500. The travelers were spotted by U.S. Customs agents transiting in Toronto or the Bahamas or their passports had a Cuba stamp—sometimes from

trips two or three years ago. The Center for Constitutional Rights, which defends travelers to Cuba, is getting 10 calls a week, triple last year's caseload, and can't take any more.

Meantime, word is filtering down to would-be Cubagoers. "I don't think I should go now," says a banker who had planned an October trip. Just what the Bush Administration had in mind. *S.P.*

TALK SHOW "...the economy will narrowly avoid recession and recover gradually next year."

—Congressional Budget Office report

WILD BLUE YONDER

TIME-SHARE THE SKIES?

MORE COMPANIES ARE FINDING time shares on private planes an alternative to corporate jets or forcing harried execs to cope with commercial travel. Fractional ownership—in which companies buy the right to use a fleet of planes at any time—is up 30% over last year, though it still accounts only 0.6% of all business trips. For companies wanting convenience and prestige of flying executives anywhere at hours, the cost of fractional ownership—about \$1 million \$5 million to buy in, plus \$6,000 monthly and hourly fees—far cheaper than forking over \$42 million for a Gulfstream. Plus, it eliminates idle time and expense at the hangar.

After watching passengers defect from business class, commercial airlines are anxious to get in the game. UAL is launching private jets next April that will boast five-star service and more amenities than United can offer, including spacious cabins and, on some planes, conference tables and lounges. "It's a much smaller universe of people, there are a number of needs commercial airlines simply cannot fulfill," says Stu Oran, CEO of United BizJet Holdings. Air Canada, British Airways, and Virgin Atlantic are planning similar services. They will join already crowded skies. Berkshire Hathaway's Executive Jet is the industry leader, with 370 planes. *Rod Kurland*



ONE JET: *Many owners*

AFTERLIVES

NEWT GINGRICH, LITERARY CRITIC

WHAT DO YOU DO WHEN you've already been *Time's* Man of the Year, provoked the wrath of Democrats, and left behind a controversial legacy in Congress? If you're Newt Gingrich, you become an amateur book reviewer. A prolific reader, the ex-environmental studies professor has been posting reviews on Amazon.com and become one of the site's Top 500 customer-ranked critics. "People were saying, 'What have you been reading?'" says Gingrich.

So he decided to tell them. His reviews—nearly 50 on works ranging from crime novels to tomes on quantum

physics and Palestinian-Israeli relations—are straightforward and plainly written. But Gingrich, who claims not to miss politics, can't help sneaking in a few asides. The novel *Hot Springs* "describes a world (the one in which Bill Clinton was raised)



A STAR at Amazon

which reminds you that crime gambling, and entertainment have a long intertwined history in America." And *Innovation in the Interwar Period* is "the one book Secretary of Defense Don Rumsfeld should read."

Ranked Amazon's 452nd-best reviewer, the former Speaker of the House ties with "Suzy Shams," stay-at-home Mom, and "happydogpotatohead," whose bio says he hails from "Easter Venus." *Heather Timmon*

THE LIST WAR OF THE MINTS

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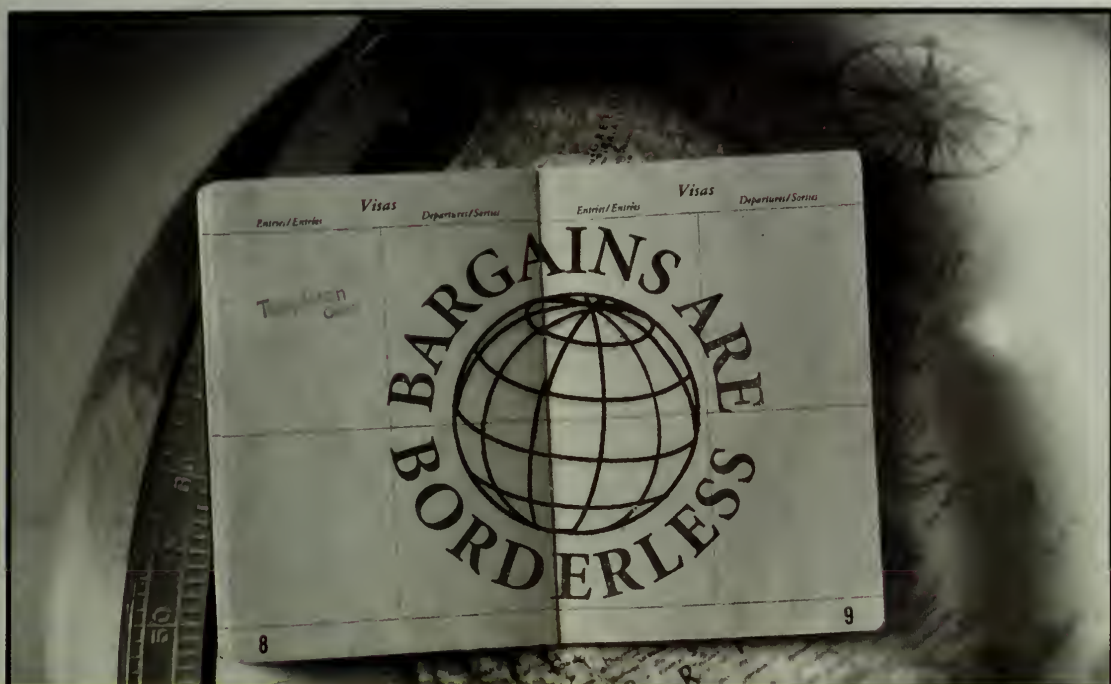
LISTERINE POCKET PAKS

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LSD-like tongue tabs; will debut in October

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< A PERSPECTIVE ON TEMPLETON GLOBAL FUNDS >



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Up Front

TYPICAL MAIL

A BIG BREAK FOR YOUR POSTMAN

HERE'S ONE BOON FROM BAD TIMES: LESS JUNK MAIL. THANKS to hefty postage hikes and the economic downturn, many companies are planning to cut back on catalogs and other direct mail this fall. Bob Wientzen, CEO of the Direct Marketing Assn., says that after years of rapid growth, most of his 4,700 members will curb "prospecting" for new customers before the holidays. Such prospects now get up to 40% of the 16 billion catalogs mailed each year in the U.S. But they're less likely to respond than proven customers. So catalogers are now "mailing smarter," says Wientzen.

Many biggies won't talk about it, but those that confirm either cutting back or marketing more conservatively include Lillian Vernon, Spiegel (which owns Eddie Bauer), and Coldwater Creek, which is cutting circulation 15%. "We will do more to target those customers prone to buying," says a spokesman for Coldwater, which is shifting its focus to online sales. Bedding-maker The Company Store has cut expansion plans 10%. Spiegel will keep circulation flat after years of growth.

Consumers may welcome less mail, but Wientzen maintains it's not junk: "The reality is that 86% of all mail that comes into the home is opened and looked at."

Diane Brady
and Julia Cosgrove



FOOD STUFF

VITAMIN-ENRICHED PROFITS

ORANGE JUICE ENHANCED with calcium was just the beginning. Sales of foods with added vitamins and minerals, a \$17.4 billion segment, are growing 7% a year. That's twice as fast as other food categories, say researchers Nutrition Business International. Such foods can fetch a 10% to 15% premium but cost just pennies more to make. A block of Nasoya tofu, for example, runs \$1.79; with added vitamin A and E it costs \$1.99. "Companies are in



it big time," says Varro Tyler, a professor at Purdue University's pharmacy school.

With money to be made, there's incentive to experiment. Goldin Pickle quickly sold out of vitamin-enhanced pickle juice in May after reports that the Philadelphia

Eagles drank pickle juice to prevent dehydration. While vinegar doesn't do much, nutritionist Susan Mitchell says the juice replaces lost salt. Belgian distributor Del Diche has a hit with Dynameat, a sausage with additives (guarana and ginseng) more commonly found in energy bars. Clearly, energy foods are taking off—in ever stranger directions.

Olga Kharif
and Kimberly Weisul

DRAWN & QUARTERED



SLAVE TO FASHION

CAT ON A HOT THIN MODEL

SUPERMODELS

Tyra Banks and Laetitia Costa love it. Christina Aguilera, Mariah Carey, and the gals from *Sex and the City* are avid collectors. The newest couture line?

No—rather, purses, bags, and T-shirts adorned with Hello Kitty. All the rage for decades in Japan and once merely the domain of little girls in the U.S., the round-faced cat is suddenly cheap chic in the fashion world.

Because the kitschy kitty is hot with fashionistas, parent company Sanrio has seen North American sales triple, to \$300 million, in the past few years. Trend analysts



say Sanrio created buzz by word of mouth, limited advertising, and new products every six weeks. "It's like an insiders' club," says Tom Julian of agency Fallon Worldwide. Pink quilted

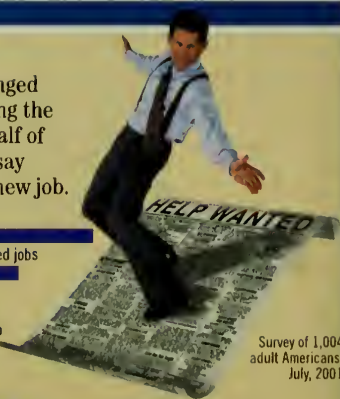
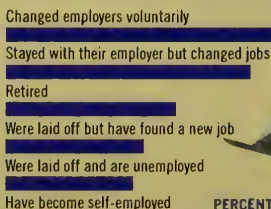
bags (\$11.50), for example, quickly sold out in June after Sanrio made only 4,800 of them.

The Hello Kitty boutique in New York's Times Square is now a celeb-sighting scene. In recent weeks, "we've had a couple Victoria's Secret models, plus Miss Dominica Republic," says nonplussed manager Rita Maskey. The Christina Aguilera of the world wanting to avoid the crowds can keep avant-garde on sanrio.com. Julia Cosgrove

THE BIG PICTURE

JOB-HOPPING

One in five workers changed employment status during the second quarter. About half of those who were laid off say they've already found a new job.



Survey of 1,004 adult Americans, July, 2001

Data: Lee Hecht Harrison



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A man with dark hair, wearing a bright green shirt, is shown in profile from the chest up. He is looking out of a window with a grid pattern. The background outside the window is a soft, out-of-focus blue and white. The text "AND I CAN MAKE ANYTHING FLY." is superimposed over the middle of the image in a dark red, serif font.

AND I CAN MAKE ANYTHING FLY.

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DIFFERENT MESSAGES FROM THE 'TELECOM MESS'

I commend Steve Rosenbush and Peter Elstrom for "Lessons from the telecom mess" (Cover Story, Aug. 13). Their analysis of the telecom industry was thought-provoking, but a few of the "lessons" require additional perspective.

First, competition is alive and well. Local phone companies are taking market share from the Bells at a rate twice

as fast as long-distance competitors achieved against AT&T after the Execunet decision. The number of competitors in BellSouth's markets has increased to nearly 300 this year. In the business marketplace, competitors serve 24% of the lines in BellSouth's region. Yet competitors have taken only about 5% of the consumer market. This is because of subsidized pricing, which has not been addressed. While consumers and business customers share the same network, competitors focus their efforts on the more lucrative business market, which has no subsidized pricing. The issue isn't whether we need more regulation—we don't. The Telecom Act directs the local Bells to enable local phone companies to compete, and BellSouth has spent almost \$2 billion and added 3,000 employees to do that.

Second, broadband deployment in BellSouth is moving at a rapid pace. By the end of 2001, we'll have 600,000 digital subscriber line customers and provide DSL access to 70% of the households in our serving area. In one year, we will have increased our DSL customer base by 180% and our customer access to DSL by 56%. *BusinessWeek*

has provided a well-written and in-depth commentary on our industry. We welcome the debate.

F. Duane Ackerman
 Chairman & CEO
 BellSouth Corporation
 Atlanta

As one who was involved in the beginning of telephone deregulation, I can only say that, for years, the people in the industry told the Federal Communications Commission and Congress what would happen—but to no avail. The regulators and lawmakers were driven by what was politically expedient and would keep them in their jobs or get them reelected.

As airline deregulation has proved, deregulation without subsidies to the high-cost users, such as travelers in rural areas and small towns, will result either in no service or unaffordable rates.

Jim Harpham
 Palm Harbor, Fla.

High startup costs, low margins, and market demographics generally don't support a profitable business case for residential local service competition, regardless of legislative intent or regulatory penalties. If the market does not support competition, neither regulatory nor legislative efforts will make it happen. Perhaps Congress would have better served the public by addressing service performance through a Telephone User's Bill of Rights, rather than by trying to mandate competition.

Regarding the article's "open standards" recommendation for the public switched network: Let's not forget that



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CORRECTIONS & CLARIFICATIONS

In "Biotech for boomers" ("America's Future," Cover Story, Aug 20-27), the name of Eli Lilly & Co.'s drug for sepsis should have been Xigiris—changed from Zovant in June.

the nationwide public switched network continues to provide the most reliable service to the most subscribers of any product or service sold in the world. Compare that performance to the poor reliability and security of the hacker-friendly Internet before getting too carried away with open standards.

Jim Strozdas
President and CEO
Quality Communications Inc.
Louisville

ROOM FOR IMPROVEMENT IN REGULATION FAIR DISCLOSURE

Securities & Exchange Commission Chairman Harvey L. Pitt said in his confirmation hearings that the underlying premise of Regulation Fair Disclosure (Reg FD) was "unassailable," but he was open to suggestions on how it could be improved ("Don't roll back fair disclosure," Editorials, Aug. 13). He said he would look to organizations such as the National Investor Relations Institute, for input.

NIRI, whose members represent more than 2,700 U.S. publicly held companies, agrees with Chairman Pitt's statement. Our 1996 "Guidelines for Corporate Disclosure" served as a blueprint for Reg FD, in terms of defining the process for achieving fair disclosure. We believe Reg FD can be improved to increase the flow of information in a number of ways, including a better definition of what is "material" information, since selective disclosure of such information is the linchpin for enforcing the rule. The SEC could provide better guidance on what companies can say in one-on-one meetings with analysts and professional investors without violating the rule. All of this can be accomplished without rolling back fair disclosure for all investors.

Louis M. Thompson Jr.
President & CEO
National Investor Relations Institute
Vienna, Va.

THE MAKING OF A BLOCKBUSTER

After two years on the market, Enbrel has experienced explosive growth—

as the fastest-selling biotechnology product ever launched ("The spoils of success," The Corporation, Aug. 13). While we continue to secure additional near-and long-term supply, Immunex is doing everything possible to help ensure that current patients are able to maintain their therapy, and that more new patients will be able to try this treatment in the future.

Building manufacturing capacity is a critical challenge for most biotechnology companies because an enormous investment of capital (over \$400 million) and time (approximately four years) is often required before it is known whether the drug works. No one knew in 1996 that Enbrel would be approved today for a market of 1 million patients.

Peggy Phillips
Chief Operating Officer
Immunex Corp.
Seattle

SILICON VALLEY DOESN'T RULE THE HIGH-TECH ROOST

The debate in "Rust belts? Try tech belts" (Science & Technology, Aug. 13) is built around contested definitions of a "high-tech" worker. The manufacturing economy that built the Midwest—the same one that has powered the nation's economy since the advent of the locomotive and the assembly line—has always called Detroit home.

As a venture capitalist in the region, I see many members of the next generation of innovators making Detroit their home. Life sciences, microsystems, optical networking, and Internet 2 are among the next-generation technologies coming of age in the Midwest.

Richard Sloan
Birmingham, Mich.

A STRONG BRAND KEEPS THE BEAR AT BAY

I found "The best global brands" (Special Report, Aug. 6) fascinating, because it's the first time I've read anything that accurately discusses the relationship between a company's core values, its brand value, and corporate valuation. Top-flight companies continually reinforce and reinvigorate their brands by extending their core values (and value propositions) across all product, service, and geographical markets in a unified, consistent way. Over time, this brand value supports and enhances the companies' corporate valuations.

Companies that continue to support their brand identity in this down market

are surviving with their corporate reputations largely intact. This is equal true in the business-to-business arena and in consumer marketing.

Marc Hausman
Silver Spring, Md.

WANT TO FIX NORDSTROM? TALK TO THE SHOPPERS

"Can the Nordstroms find the right style?" (The Corporation, July 30) summarizes, in part, what my wife has been telling me for several years: The company has lost touch with its customer base. When a salesperson responded to an observation my wife made by telling her to write the company a letter—while telling her they had "100 letters on the same subject"—that tells you something.

I also find it appalling that Nordstrom's has yet to establish a companywide computerized inventory-management system, a most basic function.

Marv Gonsky
Fullerton, Calif.

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EAKING WINDOWS

Bill Gates Fumbled the Future of Microsoft

David Bank

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ROUGH-AND-TUMBLE IN REDMOND

To the outside world, and especially to Microsoft Corp.'s archrivals, William H. Gates III is as cold-blooded as he is hard-charging. Almost on his own, the mythology goes, he arkled the PC revolution and managed steamroll any competitors that got Microsoft's way. That steely demeanor rarely softens. But for a brief moment in 1998, it crumbled.

Microsoft was being fiercely challenged by contenders such as Sun Microsystems Inc. and Oracle Corp. In addition, the federal government was ginning to slip its antitrust noose around the company's neck. Internally, Microsoft executives were sparring as never before over the future of the company. During a January board meeting that year, the usually unflappable Gates broke down, according to a new book by David Bank, a reporter for *The Wall Street Journal*.

The most powerful man in technology descended into self-pity, telling the world he was losing sleep and suffering stomach aches. Gates lost his composure and took several minutes to recover. "It was a plea for help," board member David Marquardt told Bank. A few months later, Gates handed off his responsibilities as company president to Steven A. Ballmer.

Scores of such previously untold anecdotes make *Breaking Windows* the most definitive account yet of Microsoft's step into the Internet Age. Sifting through thousands of internal e-mail messages released during the company's legal battles with trustbusters and competitors, and adding provocative reporting, Bank tails the battles that raged inside Microsoft from 1997 to 2000. He argues persuasively that those internal fights stabilized Microsoft far more than the wars the company fought in various courtrooms across the country. Along the way, he shatters any notion that

Microsoft is a monolith marching in lockstep with Gates.

As compelling as the cast of characters is, the star of the story is the rich trove of e-mail that they wrote. Bank strings together the strands of Microsoft executives' private messages to recreate the internal drama. "I am convinced we have to use Windows. This is the one thing they don't have," wrote Group Vice-President James E. Allchin, referring to Microsoft's battle with Web browser pioneer Netscape Communications Corp. "For some reason, we are in heavy copy mode against Netscape.... It is not a long-term winning strategy." And while government lawyers made hay of the unvarnished threats in those missives, Bank shows that the legal import of the e-mail pales in comparison with the strategic showdown erupting on Microsoft's campus.

The central drama in *Breaking Windows* is Microsoft's heated debate over its future. On one side were the "Windows hawks," led by Allchin, the Windows boss who was determined to protect and extend Microsoft's operating-system monopoly at all costs. Facing off against them were the "Internet doves," led by former Group Vice-President Brad A. Silverberg, who believed Microsoft was losing its relevance by dawdling on a Web strategy. The doves wanted Gates to develop a product—even if it competed with Windows—that would work as a platform to get on the Web.

Microsoft chose not to explain the internal struggle—the true context of the e-mail—during the trial, since it would have laid bare the company's strategic ambivalence. And of course, the government was loath to bring up the issue, since it would have undermined the

power of the e-mail messages as evidence. The e-mail was sent in the context of a raging turf war inside Microsoft, during which some executives raised the specter of losing ground to Netscape. But the government portrayed the e-mail exchanges as the blood lust of a rapacious monopolist. "This odd and self-serving complicity between defendant and plaintiff prevented one of the most important threads of the Microsoft story from being aired in the trial," says Bank.

For most of the past five years, Gates has had to take sides. On almost every occasion, he has stuck by Allchin. It wasn't that Gates turned his back on the Web: He just couldn't accept a product that would cannibalize Microsoft's cash cow, Windows. Instead, Chairman Gates pushed for an Internet strategy that would allow him to leverage Microsoft's Windows monopoly. "He hated the suggestion that he had to choose between the two," writes Bank. "He was open to proposals that promised to give him everything."

To Bank, that was Gates's biggest mistake. Waiting for the technical whizzes to come up with the software bits that would marry the two worlds set Microsoft adrift. Infigthing took the place of innovation, and the company's relevance began to fade far more than many outsiders realized. What's more, the strategy put the company in the direct line of fire of federal trustbusters, who successfully sued over Microsoft's attempt to use its monopoly to jump into new businesses. "Bill Gates had taken the company down the wrong road," Bank writes.

It's an interesting argument, but events of the past few months undermine Bank's thesis. Short of a court-ordered breakup, Microsoft is likely to thrive in the future precisely because of Gates's decision to hold off the Internet insurgents. By 2000, Gates had finally latched on to an Internet strategy that he could love. While pieces of that strategy, called .Net, are still emerging, it offers the have-your-cake-and-eat-it-too scenario that Gates demanded. .Net promises to let unrelated Web sites talk to one another—and to other programs



BANK SHATTERS ANY NOTION THAT MICROSOFT IS A MONOLITH MARCHING IN LOCKSTEP WITH GATES

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on a consumer's PC. For example, .NET would allow a user to purchase stock, transfer funds for the purchase, and update personal-finance software with just one click. But the key for Gates is that it will work best on Windows. At first, back in 1997, Gates's intransigence destabilized the company and put it on a collision course with the Justice Dept. But as foes wither in the sour economy and as Microsoft regains its strength, it seems that Gates's bet is paying off.

Bank also argues that the Internet does what it does best: it leaves the doves won, even if most have left the company. The author believes that, in today's computer business, winning products are those that "interoperate" with other products, not those that lock customers into proprietary technology. But in bringing out Windows XP—the version of the system due out on Oct. 25—lawmakers and rivals have accused Microsoft of using its monopoly to lock customers into other products, such as its instant messaging and digital music software.

That's why it's hard to swallow Bank's contention that *U.S. vs. Microsoft* has curbed Microsoft's worst transgression: "The antitrust trial served as a kind of remedy for Microsoft's monopoly power, tying the company's hands while competitors and, importantly, open standard and open-source software establish

It's hard to swallow Bank's claim that the trial has led Microsoft to change its ways

deeper roots," he writes. But since Bank finished reporting his book in early 2001, Microsoft has gained share in the server, database, and handheld-computer markets—businesses where competitors seemed to have dug their deepest roots.

Despite such missteps, the book lays out in vivid detail the infighting at Microsoft as never before. And unlike most other such books, *Breaking Windows* shows true insight into how the company works. Credit Bank's for years on the Microsoft beat. It's easy to find holes in his arguments, but if you're interested in understanding the workings of one of the most important companies of the past generation, *Breaking Windows* is an eye-opening read.

BY JAY GREEN

Greene is Seattle bureau chief

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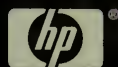
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BY STEPHEN H. WILDSTROM

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WINDOWS XP: LOOK PAST THE BAD PRESS



It is the most important Microsoft product for consumers since Windows 95

Microsoft's newest operating system, Windows XP, was sent off to manufacturing on Aug. 24 in a maelstrom of criticism. To hear detractors tell it, XP will eliminate competition in the software industry and wipe out all vestiges of personal privacy. To be sure, Microsoft has brought these troubles upon itself. For example, it picked a pointless and losing fight with Eastman Kodak, which complained Microsoft had rigged Windows to favor Microsoft's picture-handling software over Kodak's.

Something very important has been lost in the noise, however. XP is the most significant Microsoft product for consumers and small business since Windows 95 was released six years ago. With XP, Microsoft finally leaves behind the 20-year-old legacy of MS-DOS and builds instead on the much more solid foundation of the business-oriented Windows NT and 2000. And where networking was always a function grafted onto Windows 95 and its progeny, XP is built from the ground up as a networking operating system. An XP computer expects to be hooked up to a network, even if it's only a dial-up connection to the Internet. The payoff is especially great for laptops used in more than one networking setup, say at home and in the office. For corporations that have been running Windows 2000, XP is an incremental improvement. For consumers and small businesses, it's a big deal.

The current consumer version, Windows Me, is so cranky that I have been recommending Windows 2000 to consumers and small business, even though it was designed for large enterprises and can be tricky to set up. XP promises to be much more easily managed than 2000 and much better behaved than 95, 98, or Me, although individual applications may still crash. In 95-based consumer versions, an application crash triggers a warning that your program has performed an "illegal operation" or a "fatal error" blue screen. Usually you have to reboot the computer. In XP, you simply reopen only the problem application and go on working. In fact, you

may go for weeks or months without rebooting.

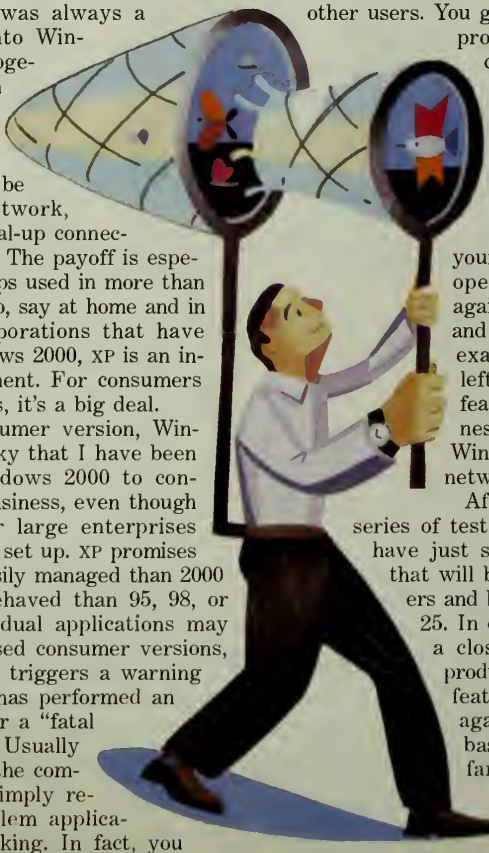
This stability doesn't come without a price. Some software and especially hardware that worked with Windows 98 may not function with XP. The critical issue is the special software called "drivers," that link hardware accessories to the heart of the computer. Drivers can crash a computer, so Microsoft made XP fussy about the drivers. Unless your device comes with drivers written for Windows 2000 or Me, it probably won't install at all. And XP objects vigorously if a setup program tries to install drivers not certified by Microsoft's Windows Hardware Quality Labs. You can override the advice and install anyway, but it's a bad idea: You may get a crash-prone setup.

The networking heart of XP is a big help here. One of the first things XP does during setup is go out to the Internet, dialing up if necessary and checking whether any new drivers are available. This means that even drivers that weren't ready for inclusion on the Windows XP CDs are being stamped out could automatically be added by the time the software goes on sale in October.

PLENTY OF PRIVACY. XP is a true multiuser operating system. This means, first, that applications installed on one computer generally are available to everyone else on a network. Second, members of a family—or employees of small business—each get his or her own account. Thus, you get your own copy of My Documents, and your data are inaccessible, and invisible, to other users. You get your own preferences for programs, your own mail accounts, your own Web bookmarks, and your own desktop layout.

When you turn the computer over to a different user, your session becomes inactive and inaccessible, but your program and files remain open. When you take over again, you enter your password and the computer returns to the exact state it was in when you left. (For security reasons, this feature is not available on business computers that log into Windows NT or Windows 2000 network.)

After months of playing with a series of test versions of Windows XP, I have just started using the final code that will be installed on new computers and be available in stores on October 25. In coming weeks, I'll be taking a closer look at this important product, examining its many new features and measuring reality against Microsoft's claims. Based on what I have seen so far, XP gives consumers the best reason to upgrade that they have seen in a long time.



BusinessWeek online

WHERE DID MY FILES GO?

For a look at some of the pitfalls lurking in Windows XP, go to Technology & You at www.businessweek.com/technology/

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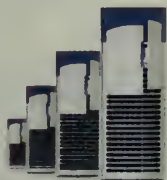
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BY JEFFREY E. GARTEN

JACK WELCH: A ROLE MODEL FOR TODAY'S CEO?



CO-BOSS:
Just about everything Welch did is worthy of emulation, but the job of CEO now may be too big for even a superstar

On Sept. 7, Jack Welch will retire from his 20-year reign as chairman and CEO of General Electric Co. (page 136). Already he has been hailed as one of the great business leaders of the past half-century—and deservedly so. Now a new generation of CEOs is emerging, including Jeffrey R. Immelt, Welch's successor, Kenneth I. Chenault at American Express, W. James McNerney Jr. at 3M, Alan G. Lafley at Procter & Gamble, Anne M. Mulcahy at Xerox, and Steven S. Reinemund at PepsiCo. As he leaves the scene, should Welch be considered a role model for this new generation of business leaders, or will they need different or additional skills? There are reasons to discount Welch as a prototype. Unlike many CEOs, he inherited a company that had been financially successful and widely admired for most of the 20th century. He also enjoyed the tailwinds of America's longest and most powerful economic expansion. Nevertheless, almost everything Welch did is worthy of emulation.

He not only identified many of the biggest ideas—globalization, quality, the shift from manufacturing to services, and e-business—he also embedded them deep into GE's culture. He combined strategic discipline—every division had to be either No. 1 or No. 2 in its industry or close down—with a culture of entrepreneurship. He handled executive development and corporate acquisitions with stunning precision.

"SPECIAL BRILLIANCE." In an interview, University of Southern California business professor Warren G. Bennis said to me: "Welch's genius was the capacity to energize and inspire hundreds of thousands of people across a range of businesses and countries." According to Harvard Business School historian Richard S. Tedlow, "his special brilliance was to make big changes before the market demanded them and before his competitors saw the need." Added Wharton School professor Michael Useem: "He could change the direction of a huge conglomerate with the speed and agility of a small firm."

I asked Welch to assess his record. "The biggest change we made, without question, was the move to a boundaryless company," he told me. "We got rid of the corner offices, the bureaucracy, the 'not-invented-here' syndrome. Instead, we got every mind in the game, got the best out of all our people." How did he do it? "My main job was developing talent," he said. "I was a gardener providing water and other nourishment to our top 750 people. Of course, I had to pull out some weeds, too."

It all paid off. From 1982 through 2000, GE's average annual total return to shareholders was

25%, compared with 17% for the Standard Poor's 500-stock index. Had you bought \$10 of GE stock at the beginning of the period, held it, by 2001 you would have earned \$677, compared with \$194,000 for an identical investment in the S&P.

Welch's record is far from perfect, of course. He himself admits to many blunders, such as the acquisition of Kidder Peabody in 1987. So critics say he relied too much on GE Capital, financial services division, which now accounts for half of the company's profits. Others point to the shortage of women and minorities in management. But perhaps Welch's biggest shortcoming was his handling of growing political and social pressures, as evidenced by the European Union's veto of the proposed GE-Honeywell merger and the Bush Administration's decision to order GE to clean up its polluting of the Hudson River at a cost of nearly \$500 million.

TOO MUCH? Indeed, for new CEOs, Welch's take-no-prisoners style, so effective when competing for customers, will need to give way to something more subtle and compromising when negotiating with governments and public interest groups. As these nonfinancial pressures are added to the already horrendously complex challenges facing global CEOs—including increasingly volatile financial markets, disruptive technologies, more intense globalization, and tenuous loyalty of employees and customers—the range of skills required may just make the job too much for one person. Welch himself made the prediction to me: "Leadership of companies is going to have to become much less CEO-driven. There's going to have to be far more delegation, far more participation [by other executives]."

It won't be easy. At Citigroup, Sanford J. Weill and John S. Reed couldn't coexist as joint CEOs. But today, Weill and former Treasury Secretary Robert E. Rubin, men with vastly different skills, seem to be working well together in a looser arrangement. At Microsoft, Chairman Bill Gates and CEO Steve Ballmer appear to be an effective team. Perhaps the same will happen at Ford Motor Co. as Chairman William C. Ford Jr. and CEO Jacques A. Nasser seek a closer working relationship. Still, no one yet claims a right formula for genuine power-sharing at the top of global enterprises.

Welch was indeed the most impressive CEO of his time. But while there is an extraordinary amount to learn from studying how he did what he did, for global business leaders, a new era is dawning as well.

Jeffrey E. Garten is dean of the Yale School of Management. A former investment banker, Garten is the author of *The Mind of the C.E.O.* (jeffrey.garten@yale.edu).

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BY GENE KORETZ

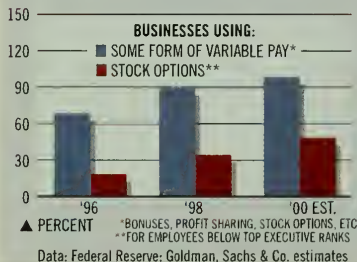
PAY PERKS CLOUD THE CRYSTAL BALL

They may help or hurt the economy

Will the growth of variable pay schemes prove to be an asset or a liability to the economy as it negotiates the recessionary shoals that lie ahead? That's the question posed by two recent Wall Street analyses—one stressing a positive aspect of flexible compensation, the other a possible negative effect.

Flexible pay practices, which link workers' pay more closely to company

THE BIG SURGE IN FLEXIBLE PAY



performance, have become increasingly popular among U.S. employers. Based on a Federal Reserve Board survey and Goldman, Sachs & Co. estimates, the percent of companies using one or more forms (profit-sharing, annual bonuses, stock-option awards, and the like) as part of compensation rose from 65% of respondents in 1996 to some 95% by last year—with stock options to less-than-top-rank executives up from 18% to nearly half (chart).

Why the trend? Companies say they use variable pay to improve hiring in tight labor markets, reward good workers, build loyalty, and control labor costs. Economists claim flexible pay can enhance productivity, lower unemployment during downturns, and temper inflation.

The latter effect is stressed by economist Joseph Carson of Alliance Capital Management, who notes that recent economic data revisions sharply raised estimates of compensation hikes in recent years (to 6.2% in 2000, for example), suggesting that business is facing a labor-cost problem. Carson points out, however, that the labor-cost rise was driven by new data on exercised stock options, which are treated as wage and salary income in the national accounts.

Moreover, it was concentrated in high-tech manufacturing, communications, and finance—the very industries granting the highest number of options.

Why were compensation hikes subdued in other industries such as health care and consumer cyclical that also issued a lot of options? Because, says Carson, their stock prices have generally been below their option strike prices, rendering the options worthless.

Thus, notes Carson, the big jump in labor costs in recent years appears not only to be “very narrow in scope, impacting mostly companies in the New Economy” but also to reflect a surge in variable compensation that will tend to wane in the months ahead. Assuming a near-term recovery, that spells good news for profits in 2002.

Goldman Sachs economist John Youngdahl agrees that a decline in variable pay should cushion profits next year. But he worries that it could also undermine consumer spending, retarding an economic upturn.

The reason is that a big chunk of variable pay in the form of bonuses, profit sharing, and stock is typically awarded in the early part of the year. In the wake of this year's profits decline, Youngdahl estimates that cutbacks in variable pay could reduce personal income in the first quarter by \$30 billion—twice the amount by which tax cuts are expected to pad take-home pay.

The danger, says Youngdahl, is that this will come as a negative shock to households, slowing consumption just as the economy is turning up. In other words, variable pay has a potential downside as well as an upside.

OLD PROFESSORS DON'T FADE AWAY

So faculty openings are limited

In recent decades, colleges and universities have kept a tight rein on faculty payrolls by raising student-teacher ratios and using lower-paid adjunct and part-time teachers. For newly minted PhDs with teaching aspirations, the light at the end of the tunnel has been the hope that most tenured faculty hired when the baby boomers entered college in the 1960s would by now start to retire as they begin to hit 70.

No such luck. While a projected pickup in college enrollments over the next decade offers some hope, the exodus of aging profs is likely to be slower than expected, report Orley Ashenfelter and

David Card in a new National Bureau of Economic Research study.

When the Age Discrimination in Employment Act was passed in 1986, Congress granted an exemption to colleges who argued that they needed to enforce mandatory retirement for tenured professors at age 70 to attract young faculty and promote the hiring of women and minorities. After two studies found that profs in states banning mandatory retirement weren't retiring later, however, the 70-and-out exemption for colleges was lifted by Congress in 1994.

Ashenfelter and Card analyze faculty turnover at a large group of institutions before and after compulsory retirement rules were banned. In the post-mandatory-retirement era, they report, some 40% of professors who were working at age 70 were still working at 73. This suggests that a sizable fraction of profs now entering their 60s are likely to remain employed into their mid-70s.

WHERE DID ALL THE SUITORS GO?

U.S. companies lose their allure

The era of massive foreign direct investment in the U.S.—a major source of dollar strength—may be drawing to a close. Economist Joseph Quinlan of Morgan Stanley Dean Witter & Co. notes that net announced merger-acquisition inflows (inflows minus U.S. investment outflows) was a paltry \$4 billion in July, compared with \$82 billion in July, 2000. Meanwhile, the backlog of net pending acquisitions by foreign investors is also down sharply (chart).

The main cause is a drop in direct investment from Europe, which on a net basis fell to just \$13 billion in the first seven months of this year, from \$104 billion in the same period last year. Domestic woes, global overcapacity, and poor U.S. profits compounded by a weakening dollar are tempering Europe's appetite for U.S. acquisitions.

Last year, net foreign direct investment covered 30% of America's current-account deficit. This year and next, the share will be far lower.

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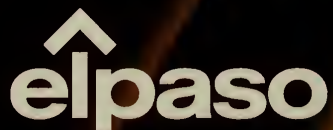
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JAMES C. COOPER & KATHLEEN MADIGAN

INVESTORS MAY BE MISSING THE BRIGHTER SIDE OF PROFITS

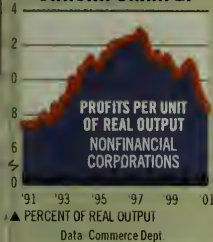
Consumer confidence is down, but so are interest and energy costs

U.S. ECONOMY

There was a time last year when bad news on the economy sent stock prices soaring in anticipation that the Federal Reserve would cut interest rates. Not anymore. Equity investors are focused squarely on profits, and they are using data on the economy as a proxy for the earnings outlook. The most recent example: Stock prices dove on Aug. 28 on news of only a small decline in consumer confidence.

To be sure, recent profit reports have made for grim reading. According to the Commerce Dept.'s Aug. 29 revisions to second-quarter gross domestic product, which included economywide data on last quarter's profits, operating earnings dropped 3.6% from the first quarter. And profit margins sank to an 8-year low (chart). The revised GDP data show that the economy rose at a mere 0.2% annual rate last quarter—even with a more rapid rate of inventory liquidation than previously reported. Still, the weakness added support for analysts who argue that continued poor revenues mean that the profits recession has longer to run.

PROFIT MARGINS HAVE SHRUNK SHARPLY



cheaper. Add in the benefits of a declining dollar and a pickup in productivity growth, and these trends imply that even if real GDP grows modestly, profits outside of that could post some positive surprises early next year.

THE GREATEST SAVING is likely to come from labor costs, businesses' biggest expense. But the savings there may not necessarily come from layoffs. True, pink slips are a quick, though brutal, way to cut costs. But thanks to lower inflation and increased job jitters among workers, employers will not have to raise pay as much or offer as many benefits to placate their workforces in coming quarters.

Labor-cost growth is already slowing. In 2000, hourly compensation rose 7.5%. But in the first half of 2001,

growth stood at a 4.8% annual rate. If labor costs rise by 5% over the next year instead of 7.5%, businesses will spend \$150 billion less on compensation.

Also, cheaper energy will have a huge impact. Although gasoline prices at the retail level are edging up, producer costs for energy have been plummeting. In June and July, the producer price index for finished energy goods fell a combined 8.1%, the biggest two-month drop since the end of the gulf war. The PPI shows that energy prices in July were back to where they were in July, 2000.

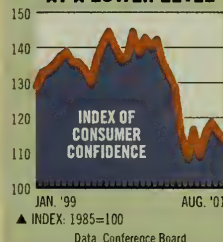
Lastly, borrowing costs are falling. In the second quarter, net interest paid by nonfinancial corporations fell 3.7% from a year ago. Part of the decline reflects a drop in loan demand, but the Fed's rate cuts have reduced the cost of borrowing, especially for small businesses that rely on bank lending.

Two other factors that could lift the bottom line in early 2002 are improved productivity and the recent weakening of the dollar. Typically, when an economy comes out of a slowdown, productivity picks up because businesses work their existing employees harder before adding workers. With U.S. companies holding an overhang of capital equipment, that trend should be especially evident into early 2002. In fact, hiring is unlikely to turn around until GDP growth is near 3%. The productivity boost should hold down unit labor costs, which means fatter margins.

The weaker dollar will help profits when companies convert overseas earnings into dollars. Its trade-weighted value has fallen 3.7% since early July, and a further decline from its exceptionally high level is likely. Unfortunately, the cheaper dollar will have little impact on boosting exports, since the global slowdown is holding down demand for U.S. products.

INDEED, REVENUES—both abroad and at home—remain the biggest risk in the profits outlook. On that score, the latest data are mixed. Although confidence has come down from its heady readings of 2000, it remains at a historically high level (chart). And July and early August data suggest that consumers are upbeat enough to keep spending at a modest pace. But falling

CONFIDENCE IS STABLE AT A LOWER LEVEL



new orders for capital goods mean that business demand and sentiment about the future are still sinking.

In August, the Conference Board's index of consumer confidence slipped to 114.3 from 116.3 in July. The board said that job jitters caused a drop in households' assessment of current economic conditions. But expectations about the economy's performance six months from now rose in August, and they have been on a rising trend since February. Household spending correlates better with consumers' expectations than with their feelings about their current situation.

The optimism is also evident in consumers' willingness to buying big-ticket items like a house. New home sales rose 4.9% in August. And although existing home sales dropped 3% during the same month, they are on track to post their second-best year ever, just below 1999's record high of 5.2 million.

THE NEWS IS MUCH LESS BLISSFUL on the business side, however. New orders for capital goods, considered a proxy for business optimism, fell 1.9% in August, the fourth decline in a row. The drop is a sign that companies, unlike consumers, are too pessimistic to commit to investing in big-ticket capital goods.

This contrast between consumers and businesses was echoed in the revisions to second-quarter GDP. Consumer spending grew 2.5%, not much different from the preliminary data. But business investment

on equipment fell 15.1%, and companies liquidated the inventories by \$38.4 billion, \$11.5 billion more than first reported. Provided that consumer demand continues to grow moderately, the sharp inventory correction outside of the tech sector is laying the groundwork for a small pickup in ordering and output.

However, weak demand for tech equipment and excessive tech inventories will continue to skew the top-line data. It may take until early next year before the tech part of the inventory problem is brought under control (chart). Part of that drawdown will come from tech companies slashing prices. That's why the tech sector is one area where the profit outlook remains dim.

But one company's fire sale is another's bargain. Nontech companies will be able to save money on high-tech equipment. And those savings are yet another gain for profits.

To be sure, the profit outlook still carries many dangers. Paramount among those is a surprise pullback by consumers, which could send the expansion into a tailspin. But companies seem to have a good handle on costs going forward. And that should be welcome news both for the economy and Wall Street.

WHERE INVENTORIES ARE WAY OUT OF BALANCE



CHILE

KEEPING THE ARGENTINE BUG AT BAY

Chile hasn't caught the Argentine flu. True, Chile's peso, free-floating since 1999, has felt the chills from Argentina's debt crisis, but the contagion stops there. Its stock market has been much less volatile than those of its neighbors, and it has little foreign-debt exposure. Chile's tough fiscal discipline helps, and its economy is outpacing those in nearly all of Latin America.

Indeed, Chile's slowdown, which began last year, may be bottoming out, based on unexpectedly strong June data on economic activity and retail sales. After growth of 5.4% for all of 2000, real gross domestic product in the second quarter grew 3.4% from a year ago, close to the first

quarter's showing, and the pace is set to quicken a little.

However, any pickup will not come as fast or as strongly as the June data implied: Those data got a boost because June, 2001, had

an extra working day and an extra weekend compared with June, 2000. July retail sales turned soft again. Unemployment stood at 9.6% in June, and the economy is not strong enough to support job growth beyond temporary government programs.

Still, second-half economic fundamentals look firmer. The central bank has cut interest rates five times this year, by a total of 1.5 percentage points. The weak peso will limit further cutting, but the

government has budgeted a 5% increase in real outlays this year, and with legislative elections due in December, the government is talking about cuts in income taxes, with revenue losses made up by higher corporate rates.

Exports will get support from the 20% drop in the Chilean peso since last year—about 12% since June. The peso's drop also reflects the global slowdown and the sharp drop in the price of copper, a crucial export. Only about 4% of Chile's exports go to Argentina, while nearly 60% go to Asia and Europe. Despite the peso's weakness, inflation is expected to slip a bit this year, from 3.8% in 2000.

Economists expect Chile to grow 3%-3.5% this year and 4.5%-5% next year. That would likely cap the best three-year performance in Latin America.

THE ECONOMY PERKED UP IN JUNE





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SPOTLIGHT ON THE BORDER



A viable plan on immigration tops the Bush- Fox agenda

Call it *The Dos Amigos Show*. On Sept. 5, George W. Bush will welcome Mexican President Vicente Fox to Washington for a two-day visit that promises to be a Texas-size extravaganza. Bush, who counts Fox as his best buddy among world leaders, aims to showcase their partnership and their two nations' growing interdependence. Fox will be showered with honors, from a celebrity-studded state dinner—Bush's first as host—to an appearance before a joint session of Congress.

Fox will take home lots more than snapshots full of smiles and a new pair of cowboy boots for his collection. The two leaders will announce a series of initiatives, including joint efforts to crack down on drug trafficking and money laundering, speeding the movement of goods across border bridges, and plans to cooperate on energy ventures. Bush will also reiterate support for allowing Mexican trucks on U.S. roads.

The centerpiece of the visit, however, will be a new framework for regulating the surging tide of Mexican immigrants. Since 1970, the number of Mexicans living in the U.S. has swelled from around 800,000 to more than 8 million, half of them illegal. The influx is part of an immigration wave that has pushed America's foreign-born to 11.2% of the total population, up from 4.7% just 30 years ago. That's the highest level since 1930, when immigrants totaled about 12% of the population.

Clearly, the Bush Administration has been laying the groundwork for an easing of restrictions. "If you can make a

living in America, and you can't find job in Mexico, family values don't stop at the southern border," said Bush in speech on Aug. 29. "People are coming to work to provide food for their families." Still, top aides have been haggling for months over how to handle the explosive issue of legalization for undocumented Mexicans in the U.S. Also on the table: a new guest-worker program that could let hundreds of thousands more Mexicans obtain temporary visas to work legally in the U.S., as well as Mexican cooperation in policing the border and cracking down on the illegal smuggling of immigrants into the U.S.

DIVIDED VOTERS. Even if Bush and Fox can broadly agree on the goals during the visit, it won't be easy to cut a deal in the months ahead. "This is an issue that is at least as complex as NAFTA," cautions Mexican Foreign Minister Jorge Castañeda. And formidable political hurdles loom. Already, Republican conservatives are fuming about even limited amnesty for illegal Mexicans, and polls show voters are divided. Many workers and lab

ions oppose creating more temporary visas, fearing more pressure on wages and a class of workers with few rights. And if the U.S. economy tanks, support for immigration could evaporate. Even so, the U.S. shift in Mexico policy is sure to kick off heated nationwide debate about immigration. Suddenly, all aspects of U.S. policy seem up for grabs as lawmakers, scholars, regulators, immigrant-rights groups, and others weigh in. How many foreigners should be admitted legally? Should admission be based more on skills or family ties? How can the flow of illegals be curbed? Says Demetrios G. Papademetriou, co-director of Washington's Migration Policy Institute: "Every corner component of the system is like-



21st century approach that views immigration not as a domestic law-enforcement issue but, like trade, as the subject of international negotiation," says Frank Sharry, executive director of National Immigration Forum, an immigration-advocacy group. In this scenario, a U.S.-Mexico deal could be a model for new pacts with Caribbean and Central American nations.

Farfetched? Perhaps, but a confluence of factors is pushing the U.S. to rethink immigration policy, especially with its southern neighbor. For the first time in decades, Washington is dealing with a legitimately elected Mexican president. Fox, a former top exec at Coca-Cola of Mexico and governor of Guanajuato state, is viewed as an honest, pragmatic leader determined to raise living standards at home, in part so Mexicans will be less likely to venture north. And Fox hopes to curry favor with Mexicans laboring in the U.S., who send home nearly \$8 billion a year in remittances and may soon gain the right to vote in Mexican elections.

Bush, a former border-state governor, is attuned to Latin American issues far more than his predecessor, Bill Clinton. He'd also like to chalk up a foreign policy accomplishment. Domestic politics plays a big role, too. He and Republican leaders are eager for Hispanic votes. GOP strategist Scott W. Reed calls Latino voters a key "stepping stone" to electoral majority in 2004.

LABOR BOON? Meanwhile, a decade of strong economic growth in the U.S. has created a warmer climate for immigration. Economists have argued that immigrant labor helped fuel the boom and keep inflation low. And businesses struggling to find workers in a tight labor market view immigrants as a safety valve.

Despite the U.S. slump, for now at least, employers are still clamoring for low-wage Mexicans to work in restaurants, hotels, meatpacking plants, and

Even if the two leaders can broadly agree on goals during the summit, finalizing a deal could be elusive

ABOVE LEFT: AFTER A FAILED CROSSING ATTEMPT, WOULD-BE ILLEGAL ENTRANTS FLEE BACK TO MEXICO, MARCH, 2000

ly to come under question."

More visas may be just the first step. "The U.S.-Mexican negotiations are the start of a

construction. "If there were a way to get more workers from abroad legally, that would be great," says Becky Duckworth, general manager of Snowmass Club in Aspen, Colo. Keeping the resort fully staffed is a chronic headache, says Duckworth. About 20% of its 300 workers are foreign, many of them legal Mexican dishwashers and chambermaids.

Union leaders, who once viewed immigrants as a threat, now see a potential source of new members. Last year, the AFL-CIO even endorsed amnesty for illegal immigrants living in the U.S.

Demographic trends are also adding to the pressure. The tide of newcomers is running at an all-time high. Ac-

cording to the Census Bureau, 9.1 million people immigrated legally in the 1990s, surpassing the 8.8 million who came in the first great migration of 1900-1910. Immigrants generated a third of labor-force growth in the 1990s, and some economists say the U.S. will need to absorb more foreigners at a steady pace as baby boomers retire.

But it's the *tsunami* of illegal immigration in particular—even with a beefed-up border patrol—that is calling into question the policy status quo. “The cold fact is that we have more undocumented immigrants today than we’ve ever had since we started counting,” says Michael Fix, director of immigration studies at the Urban Institute. “It makes sense to rethink the policy.”

Bush and Fox could hardly have picked a pricklier issue as their focus. A recent ABC News poll shows the American public divided over the idea of legal residency for illegal Mexican immi-

grants, with 43% in favor and 49% opposed. Some, such as Vincent DiMarco, a 29-year-old stock boy in an Atlanta sporting-goods store, worry about the competition for jobs. “Mexicans will work a lot harder, and a lot of the foremen are now Mexican, so they’ll hire Mexicans.” Others are less concerned. “There are so many jobs that most Americans don’t want to do,” says James McClough, a 34-year-old African American security guard in Los Angeles. “There are a lot of \$7-an-hour jobs that people don’t want because they already have two of them.”

PARTY SPLIT. Still, opposition is high among many GOP conservatives. They will try to torpedo any legalization moves, which they view as rewarding lawbreakers. They also point to the wave of illegal immigration after the 1986 legalization as proof that amnesty would only tempt more Mexicans to sneak across the border. “There’s not

likely anything the Administration can do [in the way of amnesty] that will well with the base,” says conservative fund-raiser Richard A. Viguerie.

A new temporary-visa program is also raising eyebrows among economists, who question the need just as the U.S. economy has slowed to a halt. “It doesn’t make sense to increase the supply of labor at a time when demand [for labor] is starting to falter,” says Jared Bernstein of the Economic Policy Institute. Studies show that immigration has generally depressed wages 5% for the lowest-paid Americans.

The social costs of increased immigration would also be high. A big influx of Mexican immigrants, who tend to be relatively poor, will squeeze schools and hospitals just as the sluggish economy is shrinking state tax revenue. According to a report by the Center for Immigration Studies, which opposes easier entry for low-skilled newcomers,

POLS ARE SALIVATING OVER ASIAN AMERICANS

When the 2000 U.S. Census showed that America’s minority population had soared over the past decade, Democrats could hardly contain their glee. Minorities strongly favored Al Gore over George W. Bush in the 2000 election—by 10 to 1 among African Americans—so this demographic trend seemed to favor Democrats.

But Republicans aren’t exactly despairing, either. They’ve got their sights on Asian and Pacific Americans (APAs), who are now the third-largest minority and are growing in numbers and concentration in key areas. These 12 million Asian Americans are teetering between the two parties, and GOP leaders believe the right mix of policy and politics just might sway them toward the Republicans.

Granted, Asian Americans are not poised to wield as much political clout as Latinos, who outnumber them by 3 to 1. But more Asians are spreading out beyond Hawaii, California, and New York. In nearly 100 congressional districts, Asians now make up at least 5% of the population, so in tight races, their votes could be decisive. “If you think of the Hispanic vote as a *tsunami*, the Asian

Washington Governor Gary Locke, the nation’s highest-ranking Asian American elected official



vote is like a tornado,” says Amy Walter of the *Cook Political Report*. “In certain districts, it could swoop down and make a difference.”

Asians Americans do not vote as a bloc, as African Americans, for instance, tend to do. APAs are generally among the most recent immigrants, speak different languages, practice different religions, and hail from different countries—some of which have long been enemies. Japa-

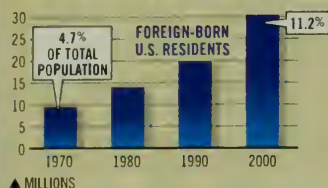
nese and South Asians, for example, skew to the Democrats, while Koreans and Vietnamese tend to be more Republican.

Still, both Democrats and Republicans see an opening. The GOP wants to appeal to Asians’ dedication to family and to their entrepreneurial instincts. Democrats insist their champion the civil rights movement and ha-

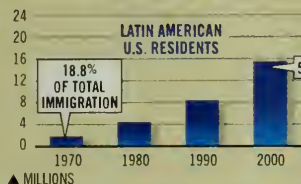
Give Me Your Tired, Your Poor

Data: U.S. Census Bureau, Center for Immigration Studies

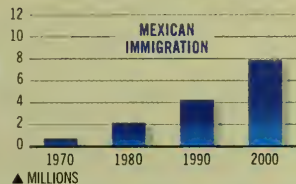
IMMIGRATION TO THE U.S. HAS SOARED...



...WITH MOST COMING FROM LATIN AMERICA...



...INCLUDING A TENFOLD INCREASE FROM MEXICO



26% of Mexican immigrants lack health insurance, vs. 13.5% of U.S. natives.

Even if the Bush-Fox proposals are enacted, they won't stem the tide of illegal immigration, given Mexico's faltering economy and wage rates that are tenth of those in the U.S. And it could take massive investment in regional development in Mexico to really make a dent, experts say. Ireland and Spain were able to stanch chronic flows of immigrants to other European nations only by shoring up their economies with hefty European Union subsidies.

Political support in the U.S. for such uses of aid for Mexico is nil. Instead,

Fox is hoping for bigger U.S. contributions to the dormant North American Development Bank, created by NAFTA in 1994 to help finance infrastructure and jobs in poor regions of Mexico. He's also using matching funds and other lures to persuade successful Mexican immigrants to invest back home.

It's a start. But the risk for Fox—and for Bush—is a backlash if the immigration initiative seems skimpy or if Washington fails to deliver. Moreover, because of the U.S. downturn, Mexico's gross domestic product will grow at 1% at best this year. If layoffs continue at export-oriented plants, more Mexicans will at-

tempt the dangerous border crossing. That could weaken support in the U.S.

No doubt the political heat could get hotter than Texas in August. But if the Dos Amigos are serious about remaking U.S.-Mexican immigration policy, it's heat they're both going to have to face.

By Amy Borrus in Washington and Geri Smith in Mexico City, with bureau reports

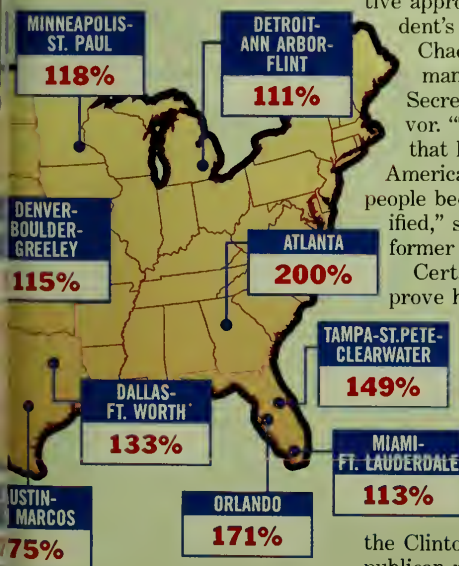
BusinessWeek online

For an interview with Mexico's Foreign Minister Jorge Castañeda, please go to the Sept. 10 issue online at www.businessweek.com

legislation makes them a natural former Delaware Lieutenant Gov. S.B. Woo has even launched the initiative, which aims to prod to deliver at least 80% of their to a particular party or candidate. at Woo became an independent

BIGGEST ASIAN INFLUX

olitan areas that had more than increase in the Asian tion from 1990-2000



to emphasize that the Asian American vote is up for grabs.

Because two-thirds of Asian Americans are foreign-born, immigration policy is a critical issue for them. This has traditionally played in the Democrats' favor; in California, for example, Vietnamese Americans started crossover voting for Democrats after GOP Governor Pete Wilson promoted policies that many deemed anti-immigrant.

But President Bush aims to lure back such Asian Democrats with a more positive approach to immigration. The President's appointment of Elaine L.

Chao as Labor Secretary and Norman Y. Mineta as Transportation Secretary could also help curry favor. "There was an appreciation that he didn't pander to the Asian American community but chose these people because they were the best-qualified," says Republican Matt Fong, a former California state treasurer.

Certainly, Bush could stand to improve his showing with APA voters.

While Asians have favored Republicans in Presidential elections, last year they cast their ballots for former Vice-President Gore over Bush by 55% to 41%. That switch occurred despite the 1996 campaign-finance scandal and the Wen Ho Lee case during

the Clinton Administration. But the Republican reaction to both scandals didn't make the GOP a savior to Asian Americans, either. "You had congressional Re-

publicans beating the drums, saying the White House was selling out the country to communist China. Asian Americans shot to prominence [in the news], but in the worst possible way," says Frank H. Wu, a Howard University law professor.

TAKING THE STAGE? Asian Americans are also running for office in greater numbers. Two decades ago, only a few hundred held public office, largely in Hawaii and on the West Coast. Today, there are more than 2,200 in 33 states—and last November, Washington elected Democrat Gary Locke as its governor, making him the nation's highest-ranking Asian American elected official. And Asian Americans loyally support members of their group even when they run in a different state. S.B. Woo estimates that when he ran for office in Delaware, 70% of his campaign funds came from Asian Americans in California, New York, and Texas.

Some activists believe their community will begin exerting much greater political influence as more foreign-born Asians become citizens and register to vote. They could be particularly influential in California, where they're about 12% of the population. "We've never been so diverse," says Don T. Nakanishi, director of UCLA's Asian American Studies Center. "At the same time, because of the challenges all Asians face in terms of discrimination, we've never been so united." That's one reason this emerging minority could be moving to the front of the political stage.

By Alexandra Starr in Washington

ican Demographics; William H. Frey, now at the Milken Institute in Santa Monica, Calif.

COMMENTARY

By Michael J. Mandel

SOCIAL SECURITY: THE ELDERLY SHOULD BEAR SOME RISK

The clouds of confusion surrounding the Social Security debate are getting thicker by the minute. The latest piece of news to roll in: a Congressional Budget Office study showing that the federal budget surplus will be only \$153 billion this year, down from the \$275 billion projected in May. As a result, some \$9 billion in Social Security revenues will have to be diverted this year to pay for general expenses.

The estimates, released on Aug. 28, ignited a political firestorm. Democrats immediately geared up to attack the Administration for raiding the retirement trust funds. Meanwhile, in an odd reversal, Republicans are defending the diversion as a necessary evil in an economic slowdown.

But both Democrats and Republicans are missing the bigger point. If we can't reliably forecast the surplus four months in advance, how can we know how much is needed in the trust funds to pay for retirement and medical costs 30 or more years in the future?

STAGGERING. The simple answer is, we can't: As policymakers attempt to gaze into the future, they are confronted not merely with enormous economic uncertainties but also with staggering questions regarding medical advances. No one knows how fast productivity will grow in the years to come. And there's no way of predicting how much new medical technologies will extend life spans, or how much these advances will cost.

Depending on the assumptions you make, the trust funds will start running out of money in 15 years, 30 years, or never.

Faced with this unknown, it's pointless to worry about \$9 billion today. Instead, we should be debating the key question: How much of the future uncertainty should be shouldered by the elderly, and how much should be borne by younger workers? Finding a fair allocation of risk between young and old is essential for making Social Security and Medicare politically and fiscally viable.

Certainly there are a wide range of alternatives. The current system of old-age entitlements, for example, effectively protects the elderly from many risks, such as an inflationary surge or an economic slowdown, after they have retired. But it also means the elderly don't share in the gains when the economy booms.

By contrast, fully privatizing the Social Security and Medicare systems, as some have suggested, could boost returns if the economy and stock market did well—but it would also shift much of the risk to the el-

derly. They would be exposed to turmoil of the marketplace, including possible financial loss and escalating medical costs.

It could be possible to find a locally palatable middle ground, where the elderly bear a piece of the economic risk, rather than being relatively immune as they are now. That would mean making old-age benefits more

sensitive to economic conditions while giving retirees some protection.

In the case of Social Security, for example, that could mean tweaking the payout formula. Right now, benefits are based on a person's average earnings when a person

retires, and then are adjusted for inflation using the consumer price index. Instead, benefits could be raised each year by an index based on wages. That means the elderly will see their benefits go up faster whenever wages do—but if real wages stagnate or fall, as they did in the 1980s, Social Security payouts. Similarly, Medicare spending could be better linked to the ability of the economy to support it.

Politically these won't be easy decisions.

THE FUTURE IS BLEAK —OR IS IT?

When the trust funds will be exhausted:

	SOCIAL SECURITY	MEDICARE*
PESSIMISTIC PROJECTION (Slow productivity growth, rapid decline in death rates)	2027	2016
INTERMEDIATE PROJECTION	2038	2029
OPTIMISTIC PROJECTION (Rapid productivity growth, slow decline in death rates)	Never**	Never**

*Hospital Insurance Fund only. **Within 75-year projection period.
Data: Social Security Administration, Centers for Medicare and Medicaid Services



Yet past attempts to find a permanent solution to Social Security and are funding have consistently faltered because the future came out less than expected. For example, changes in Social Security taxes enacted in 1977 were expected to "restore financial soundness of the cash benefit program throughout the remainder of the century and into the early years of the next one," in the words of the Social Security Trustees. But the trust funds have come close to running dry because of the unexpectedly high inflation and deep recession of the next few years, forcing another rescue attempt.

WRONG. More broadly, projections of financial soundness based on forecasts of productivity growth run the risk of being very wrong. Since the end of World War II, average long-term productivity growth has fluctuated widely, going from as high as 3% annually and as low as 1%. Faster productivity growth means a stronger economy—and that's what ultimately determines our ability to support the elderly. That's true whether or not Social Security is paid out of trust funds, general revenues, or private accounts. The future length of Americans' life expectancy is also fundamentally unknowable. Demographic projections of the number of elderly have been way off the mark. For example, in the mid-1960s, the Social Security Bureau projected that there would be 28 million people 65 years and older in 2000. In fact, they underestimated by 25%; the actual number was 35 million. Now medical scientists are working on a wave of fundamental technological advances, such as stem cell research, which could lead to big increases in life expectancy. Or life spans could turn out to be much longer than the biblical three score years and 10.

Risk is not the easiest thing for the political system to deal with. If the economy falters over the next 30 years, old-age benefits will have to be cut—there's no way around it. But only by acknowledging the uncertainty can we make policy that makes sense.

Mandel covers economic policy from New York.

THE ECONOMY

HOW LOW CAN INVENTORIES GO?

They may shrink further, delaying recovery

At this point during the last economic slowdown, in the early '90s, Behlen Mfg. Co. wouldn't have been caught dead with its current low level of inventories. Uncertain about the economy, the Columbus (Neb.) metal fabricator would have wanted its inventory-to-sales ratio to run about 1.6, or 160% more inventory on hand than total monthly sales. If demand picked up, says CEO Tony Raimondo, that's what he'd have needed to cover orders. But in this slump, that ratio is now 1.4. And by keeping a brake on supplies, Behlen hopes to be at 1.2 in six months.

Behlen has reduced inventory through better "just-in-time" management techniques. And while that's good news for the company, that may mean more sluggish times ahead for the economy.

Since last fall, the pileup in business inventories, both in Old Economy companies and the high-tech sector, have been a huge drag on the economy. As companies have cut production to get stock back in line, business inventories have fallen steadily since January. As a result, many economists now believe that the inventory decline could be close to done. That in turn would mean a turnaround as companies begin to restock in the third quarter. "Businesses aren't going to let inventories fall forever," says Benjamin Herzon, an economist at Macroeconomic Advisers, a St. Louis forecasting firm.

But have just-in-time inventory methods lowered the level of stock companies need to hold, meaning more sharp cuts instead? In congressional testimony this year, Federal Reserve Chairman Alan Greenspan suggested that the threshold has indeed fallen. And Richard Berner, an economist at Morgan Stanley Dean Witter & Co., says that the shift to just-in-time portends inventory cuts in the third quarter just as sharp as those in the second. The Commerce Dept.'s Aug. 24 durable goods report, which showed a 0.6% dip in July inventories, indicates that aggressive trimming continues. "In the just-in-time world, lean and mean is much lower than historical norms would suggest," Berner says.

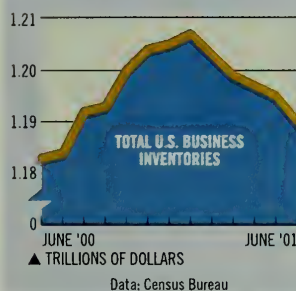
MORE CUTBACKS. Moreover, better inventory management doesn't mean companies are any better at forecasting demand—as the tech sector has amply demonstrated since fall. At computer manufacturers and makers of other electronic products, the inventory ratio has risen steadily from 1.21 last September, to 1.59 in July. With sales still falling faster than they can slash inventories, more production cutbacks are ahead. Semiconductor giant Texas Instruments Inc. has already cut inventories by 12% in the first half, yet they were four days above last year's midpoint.

So what is the optimum level of inventories to spur a recovery? According to the Census bureau, the inventory-to-sales ratio for all businesses hit 1.43 in June. That's still well above the low of 1.37 hit in March, 2000, near the height of the tech boom. Morgan Stanley's Berner predicts businesses will continue to get back to that level or even lower. That means there could still be plenty of destocking left to do.

By Robert Berner in Chicago, with bureau reports



SHORTER SUPPLY



COMMENTARY

By Rich Miller & Laura Cohn

EVEN CONSUMERS GET THE BLUES



Ever since the economy hit the skids at the start of the year, optimists at the Federal Reserve and on Wall Street have been counting on the free-spending consumer to keep the U.S. out of recession and lead a recovery. Indeed, revised gross domestic product figures released on Aug. 29 showed that the economy was able to stay out of recession territory in the second quarter thanks mainly to consumer spending. And there have been reasons for further optimism: cheaper credit from the Fed and \$40 billion in tax rebates from Uncle Sam.

Well, now that upbeat script may have to be rewritten. U.S. consumers are showing signs of strain. More and more workers are losing their jobs as companies pare payrolls to boost sagging profits. But it's not just the pink-slipped employees who are feeling the pinch. Even workers who haven't come under the ax could be in for rougher times because of slashed bonuses and higher health-care premiums. Add in a stock market that's in a funk and housing prices that may be peaking, and there's plenty of reason for concern.

In one worrying sign of a crack in the consumer monolith, the Conference Board reported on Aug. 28 that confidence fell for the second straight

MALL MALAISE? *Confidence levels are down*

month in August. Indeed, the surprise drop came even as rebate checks were being mailed.

To be sure, the fall in confidence was small. And it was all concentrated in consumers' assessment of current economic conditions. When asked about the outlook six months from now, consumers remained more optimistic.

But the downdraft in sentiment is troubling. It means that the hoped-for pop from the rebate checks could be a lot smaller than the 1% boost in growth many economists had been banking on. In fact, an Aug. 10-12 Gallup poll found that only about 25% of those taxpayers who had received checks had spent the money.

What's more, consumer optimism about the future could prove misplaced. Layoff announcements are mounting—and will likely get worse before they get better. In the closing days of August, Deere, Honeywell, and Hughes Electronics all announced job cuts.

Companies are not apt to stop

there. With profits under pressure, they will also cut back on bonuses and stock options. Ford Motor Co. said on Aug. 29 that it was eliminating bonuses for its top 6,000 managers. Last year, those payments totaled \$442 million. When the smoke clears, Goldman, Sachs & Co. economist John Youngdahl thinks companies could slash such payments by \$30 billion early next year, reducing compensation by 0.5%.

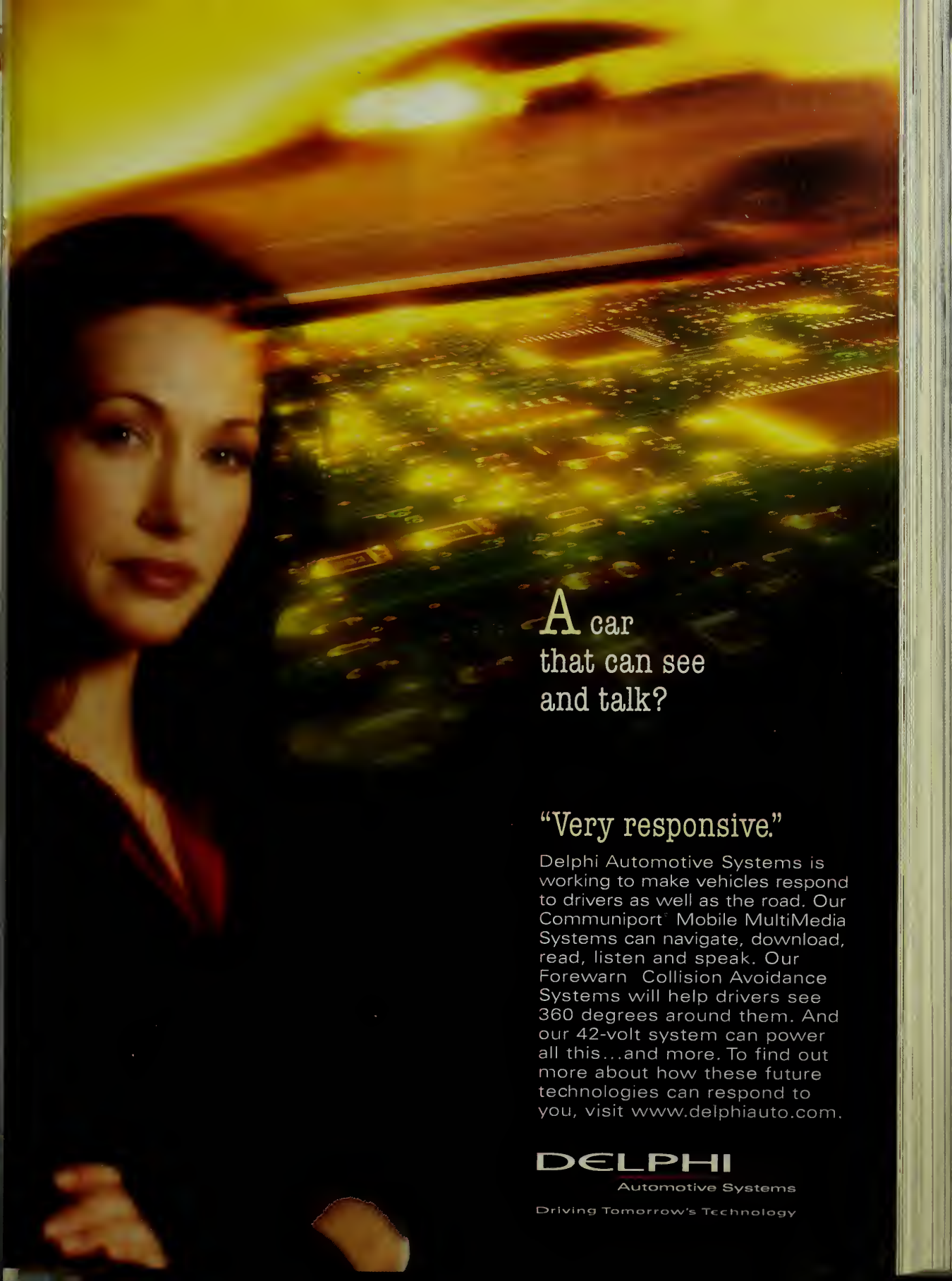
WHIPSAWED. Even as income stagnates, many workers are about to get socked with a big rise in their health-care costs. Because of rising drug prices and waning savings from managed care, health-care costs are expected to rise by 16% in 2002, the fastest rate of increase in more than 10 years, according to New York consultant Segal Co. With profits squeezed, many of those costs will be passed on to workers. Half of midsize companies surveyed in August by insurance-services firm Marsh Inc. said they intended to make workers pay a greater share of health-care costs.

Consumers are also getting whipsawed by the stock market, which has failed to rally despite Fed rate cuts. So far, rising home prices have offset some of the losses on Wall Street. But that source of strength may be ebbing. The National Association of Realtors said on Aug. 27 that the median house price rose at an annual rate of 5.2% in July, vs. 6.4% in the second quarter. And a further cooling-off is likely. Already, prices are falling in some of the hottest housing markets, such as Silicon Valley.

Add it all up, and it means the optimists at the Fed and on the Street may end up caught in their own version of a Samuel Beckett play—waiting for a full-scale recovery that never seems to arrive.

With Kathleen Kerwin in Detroit



A woman with dark hair is shown from the chest up on the left side of the frame, looking towards the camera. The background is a composite image of a city at night, with lights from buildings and streets. Overlaid on the city is a glowing, semi-transparent digital interface that resembles a car's dashboard or a navigation system, with various lines, dots, and text elements. The overall color palette is dominated by warm yellows, oranges, and greens, creating a futuristic and high-tech atmosphere.

A car
that can see
and talk?

"Very responsive."

Delphi Automotive Systems is working to make vehicles respond to drivers as well as the road. Our Communiport[®] Mobile MultiMedia Systems can navigate, download, read, listen and speak. Our Forewarn[®] Collision Avoidance Systems will help drivers see 360 degrees around them. And our 42-volt system can power all this...and more. To find out more about how these future technologies can respond to you, visit www.delphiauto.com.

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PERSONAL COMPUTERS

CAN GATEWAY SURVIVE IN A SMALLER PASTURE?

As the ailing PC maker downsizes, rivals may kick it around

Times have never been tougher for Gateway Inc., the folksy personal-computer maker that was born in an Iowa farmhouse and became king of the U.S. home-PC market in the late 1990s. Things are so bad, in fact, that the company is renting out classrooms at its 300 Gateway Country Stores. Not to folks buying and learning about Gateway PCs—there aren't many of them these days—but to anyone in the neighborhood who needs space for a meeting.

Founder and CEO Theodore W. Waitt knows that's not nearly enough to help his struggling company, which lost \$523.7 million on first-half sales of \$3.5 billion. So he took out the ax—again. Having laid off 3,000, cut marketing funds, and closed 37 stores earlier this year, Gateway said on Aug. 28 that it would cut 4,600 more jobs, bringing the workforce down by 35%. Gateway will also shut down operations in Britain, Japan, and seven other countries, which together accounted for 14% of its \$10 billion in sales last year.

NARROW STALL. Can Gateway prosper as a smaller company? Waitt believes so—and he has little choice but to try. Rather than fight for share in the money-losing PC market, where Gateway's total sales are down 25% year-to-year, he wants to reduce Gateway's reliance on hardware and take up the slack with more profitable services, such as online bill-paying and small-business tech support. "We're getting smaller," Waitt says. "I don't care if I take crap for it."

But Waitt's new smaller-is-better strategy—and his almost total reliance now on the slumping U.S. PC market—will probably mean a much diminished future for Gateway. The view on Wall

Street is that downsizing will surely cut costs, but it isn't a prescription for growth. For Gateway to be anything more than a niche player and a perpetual also-ran, says Eric Rothdeutsch, an analyst at Robertson Stephens, "a genie



THE BOTTOM DROPS OUT

Gateway has little choice but to shrink. "I don't care if I take crap for it," says Waitt

would have to appear and wave magic pixie dust over the company."

The fact is, bigger has always been better in the PC business because a large PC maker can command the best prices from suppliers. If the company isn't going to expand its core market, Waitt needs a strategy beyond cost-cutting measures. Reducing the number of PC configurations it offers or outsourcing more manufacturing isn't enough. So Waitt is putting his hopes on several

new initiatives at the remaining Count Stores. He wants to turn them from showrooms into full-fledged technology centers, where consumers can take courses on downloading music or paying bills electronically, and where small businesses can get training and round-the-clock repair services for a monthly fee. By integrating the stores' salespeople with its telephone and Net sales effort, Waitt hopes Gateway can establish stronger ties with customers. Store clerks, for instance, could go on sales calls to hawk repair services.

JUNK GRADE. The services, however, are a tough market, with Dell Computer Corp. and IBM already entrenched. And smaller resellers are willing to assemble tailor-made systems and offer support services at rock-bottom prices. That

stiff competition and the nature of what Gateway will be offering make some skeptical. "Better leveraging of the store is a sound idea, but the services being offered are not that innovative," says Tony DuBois, a computer analyst for consultant A Research.

It's not much of a game plan, but Waitt's options are limited. When he returned

Gateway after a one-year retirement last January, his initial plan was to reinvigorate the core PC business by slashing costs and offering customer low-price guarantees. But with the meltdown, that plan fizzled. Now, the stock is sinking, and on Aug. 23, Standard & Poor's Corp., like *BusinessWeek*, a unit of The McGraw-Hill Cos., dropped Gateway's bond rating to junk status. Although Gateway isn't likely to go belly-up—since it has \$1 billion in cash and virtually no debt—it is unlikely to be acquired, either. That leaves with the ugly prospect of being kicked around by rivals indefinitely. Indeed, one Dell manager revved up his sales force by taking a cake decorated to look like Gateway's cow mascot into a meeting and beating it to a pulp. If Waitt fails, Gateway may become the perpetual 98-pound weakling of the PC biz.

By Arlene Weintraub in San Diego with Andrew Park in Dallas

Gateway's New Horizons

With PC sales and profits plunging, CEO Ted Waitt is making big changes

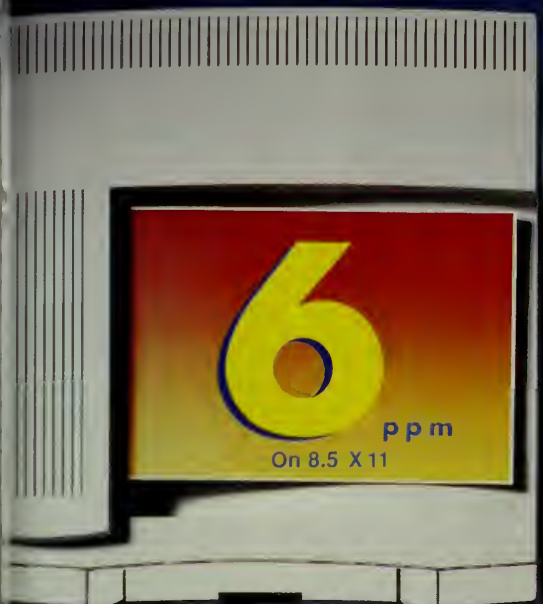
SLASH COSTS Waitt has laid off 7,600 workers, closed 37 stores, and trimmed plant spending—and is shuttering operations in nine countries

BOOST SERVICES Gateway aims to offer such subscription services as online bill paying and in-home training classes for its business and consumer users

WOO SMALL BIZ For companies too small to have their own staff, Gateway wants to become the virtual IT department, offering on-call technical support

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COMMENTARY

By Jay Greene

WHY XP WON'T SWELL MICROSOFT'S COFFERS

Just hours after Microsoft Corp. engineers completed the new Windows XP operating system on Aug. 24, the marketing team went into overdrive. Usually, the gearheads quietly hand off the software code to computer makers, who begin the month-long process of testing and installing the software. Not this time. Microsoft invited the media to watch Chairman William H. Gates III personally hand the code to execs from the six biggest computer makers on gold disks, nicely packaged in custom-labeled silver attaché cases. Then the execs boarded two helicopters that whisked them to the airport so they could begin building computers to run Windows XP. "With Windows, it's hard not to use superlatives," Gates gushed.

Gates calls the new operating system, set to launch on Oct. 25, Microsoft's most important product since Windows 95. One reason is new features, such as digital photography and instant messaging. Those additions have sparked fear among rivals and trustbusters that XP will again allow Microsoft to ratchet up its power using its Windows monopoly. A new judge in the antitrust case



MEDIA EVENT: Gates gave PC execs their XP disks in silver attaché cases

that this is Windows 95 all over again," says Al Gillen, an analyst at market researcher IDC. "But market conditions are just too different."

The sour economy will keep consumers out of stores and corporations on the sidelines. That's why IDC thinks Windows XP sales growth will hover around 5% in its first year vs.

largely content. In 1995, there were only 150 million PCs worldwide, with huge software innovations on deck. Then Win98 came out just as the Internet boom turbocharged PC demand. And Windows 2000 has gradually taken over the corporate PC market. But today, nearly 500 million PCs have been sold, and many of the features XP will offer already exist, such as instant messaging. "It's going to be harder and harder to find a new buyer," says Drew Brosseau, an analyst at SG Cowen Securities Corp.

That's true for the upgrade market, too. Six years ago, consumers lined up outside computer retailers in the dead of night to buy Win95. Not this time. The memory, disk space,

and processor speed required for XP limits customers to those who've bought high-end PCs in the past two years. And even they aren't likely to shell out



WIN98
JUNE LAUNCH



WIN95
AUG. LAUNCH

WINDOWS XP HAS SOME TOUGH ACTS TO FOLLOW

MICROSOFT OPERATING INCOME FISCAL YEAR ENDS JUNE 30

Data: Bloomberg Financial Markets

DEC. '94
\$520
MILLION

JUNE '95
\$532
MILLION

has scheduled a Sept. 21 hearing at which questions about Windows XP will likely surface.

But strip away the hype and legal maneuvering, and it becomes clear that XP just isn't going to provide the sort of performance blast that Windows 95 did. That launch spurred a 62% surge in overall sales and a 27% gain in operating income during the quarter it was released. "If you listen to Microsoft, you get the impression

Windows sales in the previous year. Contrast that with 1995, when Microsoft's platform-product group sales, which consist largely of Windows revenue, spiked by 104% in the quarter Win95 launched. Even Win98, little more than a tweaked version of Win95, triggered a 38% jump in platform-product group sales in the first full quarter after its release.

It isn't just the lousy economy that could hold XP back. The market is saturated, and consumers are

the \$99 to \$199 it would cost to upgrade to XP, since their machines already perform at a high level.

The challenges have set Microsoft's hype apparatus in gear. It plans to shell out \$200 million on a marketing campaign in the four months after the launch. And it expects chipmakers, PC makers, and electronics retailers to kick in \$800 million more. XP will be an improvement: It will be less likely to crash than earlier versions of Windows, and it will give users quick access to music and pictures.

Still, despite the marketing blitz, the sorry state of the economy and the PC market could dim Microsoft's prospects. Chances are Gates won't need superlatives to describe Windows XP's results.

Greene covers Microsoft from Seattle.



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TECHNOLOGY

A DO-IT-YOURSELF PLAN AT CISCO

No more reliance on acquisitions

Over the past eight years, Cisco Systems Inc. made a fortune for itself and its shareholders by perfecting the art of innovation-through-acquisition. The giant maker of Internet networking gear has used its turbocharged stock to gobble up more than 70 companies since 1993, integrating technology startups into a massive Silicon Valley powerhouse. Today, about half of its \$22 billion in 2001 sales can be traced to an acquired company or technology.

That strategy is about to change radically. With its shares off 79%, to just \$17, since its March, 2000, high, Cisco's acquisition engine has slowed from 23 purchases in 2000 to just five this year. As a result, it has to find a new way to stoke revenues and fix its tarnished image on Wall Street. So now CEO John T. Chambers wants to concentrate on developing products and technologies in-house through Cisco's own engineers.

That will be a tough task for a company that has always been far better known for its financial acumen and sales machine than as a developer of dazzling new stuff. It "is not going to be an easy process," says Martin Pyykkonen, senior analyst at investment bank C.E. Unterberg, Towbin. "Cisco has a world-class sales and marketing organization, but it doesn't have the R&D you would expect from a company its size."

The shift comes as part of a broad reorganization Chambers announced on Aug. 23. Key executive roles are also in flux. Mario Mazzola, who flirted with retirement last year after running Cisco's corporate products division, will now oversee all product development,



Can Chambers reignite growth with a reorganization?

in effect making him No.2. in the company. And Chamber's former big picture guy? Michelangelo Volpi, who oversaw much of Cisco's acquisition binge as chief strategy officer, will now run the Internet switching and services unit and report to Mazzola.

LESS OVERLAP. Cisco will also carve its product-development unit into 11 technology-specific groups and eliminate three customer-oriented units. Chambers is counting on the moves, in part, to stomp out redundant engineering efforts and boost accountability. Earlier this year, for instance, several divisions were working on similar router projects all geared toward the same customers. "This will help us get a lot more wood behind each arrow," says Mazzola.

But can Mazzola quickly morph Cisco from a savvy buyer of technology to a full-fledged innovator? After all, creating products on your own is entirely different from buying technology and improving on it or integrating it with other products. Furthermore, considering Cisco's entrenched product lines and formula for success, it won't be easy getting ex-

ecutives to suddenly chase new ideas. "The bigger a company is and the more legacy it has, the harder it becomes to innovate," says one former Cisco executive. "People are less likely to think about something in a totally new way."

Success may also require a bigger budget. Sure, Cisco spent about 22% of sales this summer on research and development, on par with rivals like Nortel Networks and Juniper Networks. But quickly squeezing winning product out of R&D without dramatically hiking its budget will be a stretch. "That's going to be a big question," says Merri Lynch & Co. analyst Sam Wilson.

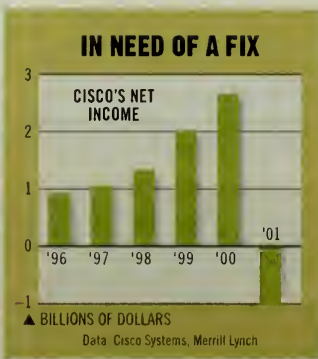
To be sure, Cisco has had homegrown hits. Its recently released The 12000 Internet Router helped it win back about 5% of the high end of that market from Juniper Networks in the second quarter, according to Infonetics Research.

But Mazzola, a top-flight operation man, will have to build on that success if he hopes to pull Cisco from its Internet slump. After joining Cisco in 1999 through its acquisition of Crescendo Communications, he built the company's switching business from scratch to more than 40% of its \$22.3 billion in 2000 sales. "He's a remarkable technologist with a good feel for product trends and fits," says Redpoint Ventures partner Geoff Yang, who sat on Crescendo's board. He had better be. Otherwise, he might start regretting that he didn't opt for retirement.

By Ben Elgin in San Mateo, Calif.



MAZZOLA



our co-workers can celebrate your promotion to partner.
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The last time you had balloons at your party, you were turning thirteen. And yet, as you look back over a career of smart choices, it hits you that this time is just about as exciting. To understand what moves business, you have to understand what moves business people.



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COMMENTARY

By Amy Barrett

DRUG SAFETY NEEDS A SERIOUS OVERHAUL

Consumers taking some popular prescription drugs may find their heads spinning these days. On Aug. 8, Bayer withdrew its cholesterol-lowering drug Baycol after a series of deaths from a rare muscle-related side effect. Then on Aug. 21, a study from a Cleveland Clinic analysis of existing clinical trial data prompted concerns that two popular arthritis pills known as Cox-2 inhibitors may raise the risk of heart problems. Yet the Food & Drug Administration says other cholesterol drugs on the market are safe, and Merck & Co. and Pharmacia Corp., makers of the Cox-2 drugs, say the data on their pills show no cardiovascular risk. Small wonder patients who suffer from heart disease and arthritis want to know what's going on.

The debate about these drugs highlights a major problem with the regulatory process: The system for tracking the safety of prescription drugs after they hit the market is inadequate. The FDA spots those problems mainly through voluntary reporting by physicians when patients have bad reactions. But by the FDA's own estimates, no more than 10% of these reactions ever get reported. "We know how many suitcases were lost last year by the airlines," says Dr. Raymond L. Woosley,

vice-president for health sciences at the University of Arizona. "But we don't know how many people have been harmed by prescription drugs."

While that flawed system has long been in place, concerns about those weaknesses are mounting. In part, that's because the FDA sped up new-drug approvals in the 1990s, a slew of new products have hit the market in recent years. Drug-makers have also ramped up their marketing. Merck and Pharmacia spent \$239 million last year on consumer ads for the Cox-2 drugs Vioxx and Celebrex. Launched less than three years ago, global sales should reach \$6 billion this year. Such giant rollouts mean more patients can be hurt when a problem surfaces. Fixing this system will require effort on the part of many players in the medical system. Here are some remedies:

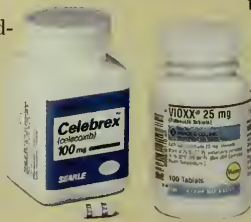
■ **EDUCATE DOCTORS.** Dr. Peter K. Honig, director of the office of post-marketing drug-risk assessment at the FDA, argues that medical schools are not putting enough emphasis on training doctors to report bad reactions. Medical schools and professional groups must mount a major push for doctors to make this a priority.

■ **ENSURE THAT WARNINGS ARE HEEDED.** In the case of Baycol, the label warned as early as

December, 1999, that the product should not be taken with another heart medicine called gemfibrozil. But physicians continued prescribing the two in combination. Of the 31 deaths related to Baycol that are on file with the FDA, 12 involved patients taking both drugs. The FDA needs a system that rapidly pulls data from managed-care operators to show whether doctors in those networks are heeding new warnings.

■ HUNT FOR PROBLEMS.

How can the FDA do that? The agency recently linked up with a network of transplant centers,



BIG NUMBERS:

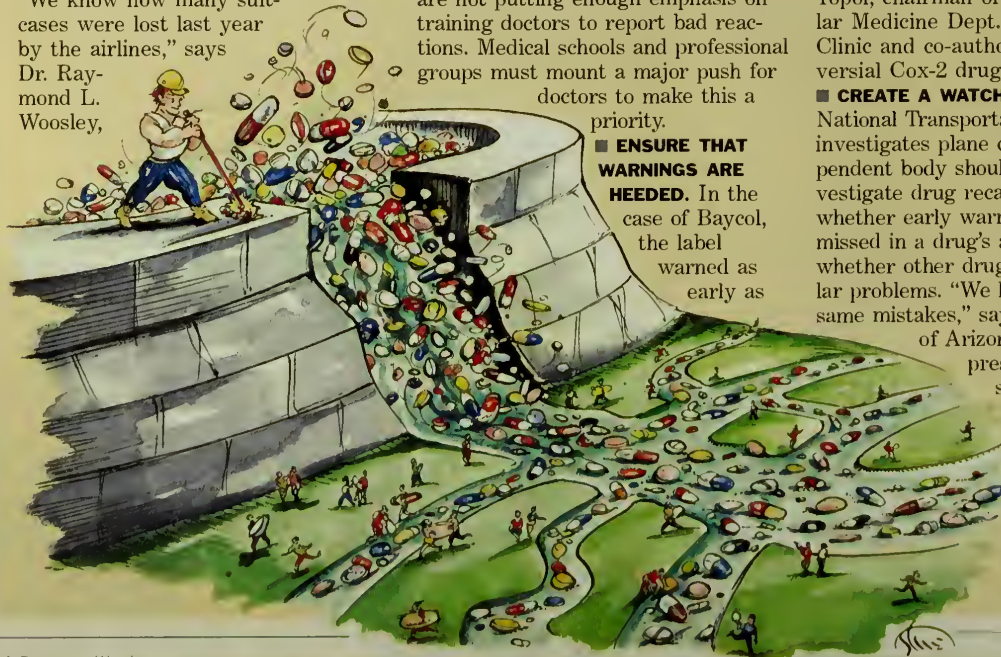
Giant rollouts get more patients to take new drugs

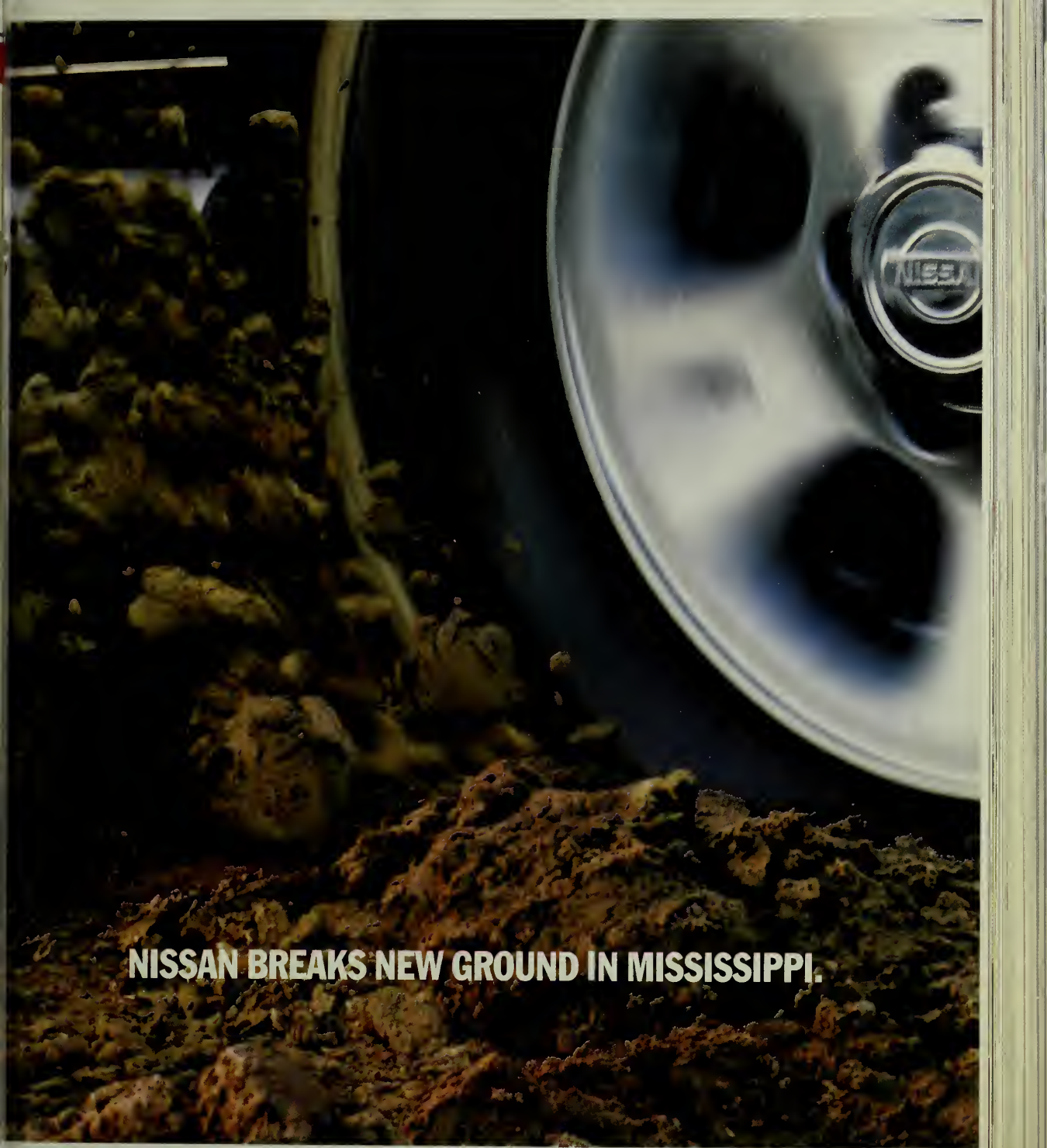
for example, to get information on the causes of liver failures among their patients. Liver damage can be caused by a bad drug re-

action. While the FDA has a few such partnerships in pilot studies, the agency needs to establish many more of them, which Congress should quickly fund. "The clustering [of bad reactions] would become evident very early rather than a year or two later, after a lot of people had a problem," says Dr. Eric J. Topol, chairman of the Cardiovascular Medicine Dept. at the Cleveland Clinic and co-author of the controversial Cox-2 drugs report.

■ **CREATE A WATCHDOG.** Much as the National Transportation Safety Board investigates plane crashes, an independent body should be set up to investigate drug recalls. It would assess whether early warning signs were missed in a drug's approval or whether other drugs could have similar problems. "We keep making the same mistakes," says the University of Arizona's Woosley. With prescription drug sales soaring, the price of such mistakes will only mount.

Philadelphia Bureau Chief Barrett covers the pharmaceuticals industry.





NISSAN BREAKS NEW GROUND IN MISSISSIPPI.

MISSISSIPPI
USA

After over 40 years of building some of the world's most innovative cars and trucks, Nissan is breaking new ground once again. This time in Canton, Mississippi, with the construction of a brand-new, leading-edge assembly plant. This plant will have the capacity to build some 250,000 Nissan full-size trucks, full-size sport utility vehicles and the next generation Nissan minivan. All to meet the

increasing demand for Nissan products in North America. Of course, along with creating some of the world's most impressive vehicles, this Nissan plant will also create an impressive number of jobs—potentially 4,000—as well as provide a catalyst for further economic development in Mississippi. In other words, Mississippi's helping Nissan leave everyone else in the dust. For more information on this historic partnership, visit www.mississippiandnissan.com

NISSAN

In Business This Week

EDITED BY MONICA ROMAN

MORE MONEY WOES FOR EXCITE@HOME

THE FORTUNES OF BROADBAND provider Excite@Home took a turn for the worse as one of the cash-strapped company's lenders demanded repayment of \$50 million. Promethean Asset Management, a New York hedge fund that led a \$100 million investment in the company in June, said Excite@Home had to repay the \$50 million by Aug. 31 because it had misrepresented its financial state at the time of the original loan. Only two months after Excite@Home raised the new capital, its auditors said the company may not survive. Excite@Home may have to file for bankruptcy to protect what little cash it has left. The company said in a statement that the repayment would "have a materially adverse impact on the company's liquidity and its ability to fund its operations." Separately,

former White House Chief of Staff Mack McLarty is advising an investor group that is weighing a stake in the company.

CA BEATS BACK AN INSURGENCY

A PROXY CHALLENGE BY Texas billionaire Sam Wyly was defeated on Aug. 29 when shareholders of Computer Associates voted to reelect the company's 10-member board. The battle was a wake-up call for management of the ailing software giant. Already, the board is looking for two additional outside directors—which would bring the total to nine. It has hired a corporate governance consultant. And management has explained its pro forma accounting methods for software sales, which had confused some investors.

TWO PAPER PLAYERS BIND TOGETHER

THE PAPER INDUSTRY, WHICH has been consolidating into a business of fewer, bigger players, shrank its roster further on Aug. 29 as Mead and Westvaco announced a stock-swap merger. The new company, MeadWestvaco, will be headed by the chiefs of the predecessor companies and have roughly \$8 billion in annual sales. It will be based in Stamford, Conn., Westvaco's headquarters, though it will retain offices in Mead's home of Dayton. MeadWestvaco will be the No. 2 producer of coated paper, behind International Paper, which has been gobbling up rivals to dominate the industry.

EARLY MANEUVERS IN THE GAME WARS

PLAYERS IN THE GAME-CONSOLE wars are jockeying for position ahead of the holiday sell-

HEADLINER: GREG WHALLEY

IN THE LINE OF FIRE

GREG WHALLEY KNOWS A thing or two about getting ready for battle. During the 1980s, the West Point graduate served with the U.S. Army. That experience could come in handy in his new job as president and chief operating officer of Houston energy trader Enron.

Since the beginning of the year, Enron shares have plunged 50% in the wake of dropping energy prices. The stock has also been hit by fallout from other issues, including the company's ailing broadband venture and the abrupt, Aug. 14 resignation of President

and CEO Jeffrey Skilling. Following Skilling's departure, Whalley, 39, was promoted along with

Mark Frevort, who was named vice-chairman. Both were elevated to the office of the chairman.

Whalley is now seen by outsiders as the leading contender for Enron's top post.

But Chairman Kenneth Lay, who reassumed Enron's CEO title when Skilling stepped down, cautions that the promotions should not be viewed as the last word in the company's succession plan.

Stephanie Anderson Forest



CLOSING BELL

ACHING BACK

Herman Miller, whose Aeron chair was the darling of the dot-com set, is feeling the pinch as commercial construction stalls. Since mid-August, shares have slipped 7%, to \$23.60 on Aug. 29. Two days earlier, it warned that sales in the quarter ending Sept. 1 would be \$405 million to \$420 million, vs. forecasts of as high as \$485 million.



ing season. On Aug. 23, Nintendo said its new GameCube console will arrive in U.S. stores on Nov. 18, two weeks later than expected. While the later date could curb holiday sales, Nintendo says it wants to have more units available so customers don't go home empty-handed. Microsoft plans to delay the Japanese launch of its Xbox console by two months, pushing the debut to Feb. 22. It, too, wants to focus on the U.S., where it will roll out Xbox on Nov. 8. Although three companies will fight it out in the U.S., only two will do battle for holiday sales in Japan.

ERICSSON AND SONY CONNECT

SWEDEN'S ERICSSON AND Japan's Sony confirmed a joint venture of their wireless phone units is on track to start Oct. 1, squashing ru-

mors that the deal could collapse. The new London-based company, to be called Sony Ericsson Mobile Communications, will have capital of \$50 million and employ 3,500 people. The companies said the venture would challenge Nokia and Motorola, the industry's top two handset makers. The opportunity is ripe: Market leader Nokia lost share in the second quarter, falling to 34.8%, according to researcher Gartner Dataquest. Ericsson regained the No. 3 spot, climbing to 8.3% from 6.8%.

ET CETERA...

- Sun Microsystems said may not turn a profit in its first quarter.
- Delta flight attendants filed a petition calling for a vote on unionization.
- Philip Morris will raise its quarterly dividend by 9%, to 58¢ from 53¢.



1st kiss

233rd kiss

4,115th kiss

*butterflies haven't
gone away*



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in the businesses of electricity, gas and

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strengths of our energy-related companies.

Strengths that include the consistent

generation, transmission and delivery of

power to millions of customers every second

of every day. So, although we're structured

for stability, when it comes to the future, we

have no intention of standing still.



Progress Energy

BY RICHARD S. DUNHAM

THE BUDGET MESS: THE DEMS MAY BE FUMBLING THE BALL

Responding to a slumping economy, the first-year President proposed a bold tax-and-budget plan. Opposition lawmakers ridiculed the proposal as an irresponsible scheme that would wreck the economy for years to come.

That has been the Democrats' tack since President Bush proposed his tax cut in January. The I-told-you-so chorus got louder on Aug. 28, when the Congressional Budget Office said the government would have to tap the Social Security surplus in 2001—and for several years. "This is not just 'the economy, stupid,' it's fiscal mismanagement," says Gene Sperling, a top economic adviser to President Clinton.

But the Chicken Littles should heed recent history before declaring Bush a fiscal failure. Eight years ago, Republicans said Clinton's economic stimulus and deficit-reduction plans would bring recession. What followed was the longest stretch of prosperity in U.S. history—and a big Clinton reelection win. It just goes to show that partisan predictions of doom have a way of looking foolish in the broad sweep of history.

BAD TIMING. True, the current \$9 billion shortfall in nonpayroll tax revenues could crimp Bush's plans to hike defense spending and partially privatize Social Security. But while Democrats think the plunging surplus is a disaster for the White House, they should temper their enthusiasm with the understanding that they, too, face significant political risks if they stick to their game plan.

Atop the list: overdoing criticism of the tax cut. The Dems blame Bush's plan for frittering away the surplus in eight months. But the attacks come just as anxious Americans are cashing rebate checks designed to head off a recession. "Democrats are in an awkward position," says Claremont McKenna College political scientist John J. Pitney Jr. "Whether you're

a Keynesian or a supply-sider, you believe tax cuts stimulate the economy. The timing works in Bush's favor."

Many liberal economists believe the best way to prevent a raid on the Social Security trust fund would be to cancel future installments of the tax cut. But Democratic leaders think it would be political suicide to call for tax hikes or deficit spending now. That gives them only one choice: cut spending.

That's just the debate the GOP covets. Hill Dems are committed to spending hundreds of billions on a prescription-drug benefit for seniors, education, and cash for farmers. With the

kitty falling from \$119 billion in May to minus \$9 billion, there's no way to fund all that. Democrats are "kicking and screaming because the tax cuts took away their spending money," says House Budget Committee Chairman Jim Nussle (R-Iowa).

Democrats are passing the buck, asking Bush to show them his cuts before they show theirs. House Minority Leader Richard A. Gephardt (D-Mo.) suggests defense, education, and welfare cuts but won't get specific. Republicans, meanwhile, say they're eager to trim spending. "I hope our Democratic friends will not feel any pain and will redeploy fed-

eral spending from lower-value to higher-value uses," says Office of Management & Budget Director Mitch Daniels.

While Democrats publicly view the budget mess as a political opportunity, some strategists worry they'll be typecast once again as the party of doom, gloom, and big spending. "The potential for Bush coming out of this looking good is scary," frets one veteran Democratic operative. Like the GOP eight years ago, Democrats can only hope for the worst. While the strategy might pay off in the short term, it's an unlikely road map to the White House in '04. Just ask President Dole.



OMB'S DANIELS: *The GOP wants spending cuts*

CAPITAL WRAPUP

GARBAGE AS HISTORY

► Interior Secretary Gale Norton raised a stink when she put the Fresno (Calif.) toxic dump on her first list of National Historic Landmarks. But some Clintonites deserve credit too. In May, members of the National Park System Advisory Board appointed by Norton's predecessor, Bruce Babbitt, voted to confer landmark status on the dump, which was the first to layer and compact its trash. Norton, unaware that the site has been on the EPA's cleanup list since 1989, O.K.'d the decision on

Aug. 27. But garbage in, garbage out: Norton dumped the historic status a day later when the sludge hit the fan.

EVER-EXPANDING TAX CUT

► How big is Bush's tax cut? The Congressional Budget Office says it will cost about \$1.3 trillion through 2011. But many of its provisions expire, and the entire plan is repealed in 2011. Bush vows to make the cuts permanent. CBO says that would up the cost to \$1.7 trillion. Add the interest on the borrowing needed to fund the plan, and the price tag goes to \$2.2 trillion.

CONSTITUENT SERVICE

► James Buchanan, widely considered one of America's worst Presidents, does not get much respect, but one congressman says he deserves federal aid. Joseph R. Pitts, a Republican who represents Buchanan's hometown of Lancaster, Pa., wants the feds to subsidize upkeep of the burial sites of Buchanan and 28 other Presidents whose graves are not maintained by the National Park Service. Pitts, usually stingy with government funds, says he wants to guarantee ex-Presidents dignity in death.



Business is angry. One CEO says the Chancellor "has gone too early into campaign mode"

SCHRÖDER IS FAR AHEAD IN THE POLLS

at lower pay scales. But overall, Schröder's government has put the brakes on reform just as growth has slowed to zero and aggressive measures are needed. "We're definitely not happy," says Karl-Josef Neukircher,

CEO of MG Technologies, the Frankfurt engineering and chemical company formerly known as Metallgesellschaft. Say another chief executive: Schröder "has gone too early into campaign mode."

On a political level, Schröder's decision to shelve reforms looks justified. In every poll, he still beats his two most likely opponents from the opposition: Christian Democrats, party Chairman Angela Merkel and Edmund Stoiber, prime minister of Bavaria. But a year is an eternity in politics. German middle-class voters, who have switched back and forth between the major parties, may yet turn on Schröder if the economic malaise deepens. German growth stagnated in the second quarter, and unemployment rose to 9.2% in July from 8.9% in June.

What's more, Schröder now runs the risk of permanently alienating the corporate lobby, which represents not only the major companies but Germany's influential *Mittelstand*—the small and midsize companies that make up the backbone of the economy. The Christian Democrats are already making a bid to regain their place as the party of business. On Aug. 27, the center-right party unveiled a draft economic plan. One key feature: a proposal to loosen Germany's job-protection law, which makes it difficult and expensive for companies to lay off workers. That answers demands by business for a more flexible labor market.

GERMANY

SCHRÖDER TAKES A LEFT TURN

Politics push the Chancellor to abandon reform

Jürgen Peters, vice-president of the IG Metall steel and auto workers union, warned Chancellor Gerhard Schröder last year that his cozy relationship with business wouldn't last. Today, Peters feels vindicated. "I prophesized this," he says, jabbing a finger and raising his voice. Now, adds Peters with a smile, Schröder knows who his real friends are.

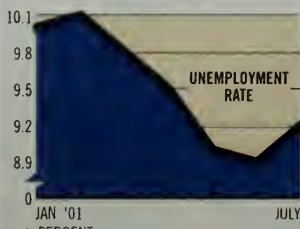
In fact, the goateed Peters, known as one of Germany's most militant labor leaders, may have a point. Just a few months ago, business was hailing Schröder as a champion

of reform. They loved his tax cuts and applauded steps to encourage Germans to take more responsibility for their own pensions. But then Schröder, leader of the center-left Social Democrats, decided not to test voter tolerance

any further ahead of elections in a little over a year. The new initiatives have all but stopped.

Now, business leaders are complaining bitterly about their onetime hero. True, Schröder is still helping companies here and there: Witness the recent deal he brokered to let Volkswagen hire new workers

GERMAN JOBLESS RATE JUMPS UP



Data: Bundesbank

get, and puts pressure on Schröder to respond.

Trouble is, he probably can't: German unions are unalterably opposed to anything that would make it easier for members to lose their jobs. Besides, unions claim they've already made enough concessions by allowing companies to hire temporary workers. "How can anybody say the system is inflexible," says IG Metall's Peters, whose union represents 3 million workers. That's more votes than any business group can mobilize.

AT BOTTOM? For now, Schröder's strategy seems to be to wait for the economy to pick up on its own, relieving him of the need to push through draconian measures. There are hopeful signs. In July, the IFO Institute survey of business confidence rose for the first time since January. Consumer spending has improved, fueled by income-tax cuts. And data on inventories show that German companies are working off excess stock faster than expected. Still, no one knows whether the economy has touched bottom or is simply pausing before heading south again. Schröder is likely to latch on to the more optimistic scenario, encouraging him to take a passive approach. "The readiness to reform has gone now," says Hubertus Schmoldt, president of the Industrial Union for Mining, Chemicals & Energy.

In fact, in some ways Schröder has backtracked on economic change. For example, he supported a law that bolsters the power of worker councils to influence company policy. Detractors say he law, a pre-election gift to labor unions, boosts bureaucracy and costs, especially for the hard-pressed *Mittelstand*. Such backpedaling has lowered economists' appraisal of Schröder. What we've seen is a little improvement [here] and there, but not a consistent strategy to improve the economy," says Jürgen von Hagen of the Bonn-based Center for European Integration Research. Von Hagen is pushing for reform of the welfare system, which says unemployed Germans more than they would earn in a low-wage job.

Schröder, the consummate politician, could yet switch direction again. Should his opposition's economic plan prove popular, the Chancellor won't hesitate to adopt some of its features. And while he has leaned toward labor recently, Schröder still meets from time to time with business buddies such as DaimlerChrysler CEO Jürgen E. Schrempp. "He is a man who listens," says Schrempp. "I think business should give him a chance." Right now, though, Schröder the politician has won over Schröder the reformer.

By Jack Ewing in Frankfurt

FRANCE

AN ENCORE FOR FRENCH CINEMA

Less arty movies are once more pulling big audiences

Claire Guillemeric is on a pilgrimage. Like dozens of gawkers every week, the 16-year-old tourist from Brittany has trekked to this quiet corner in Paris' Montmartre district to check out the family-owned produce market made famous in the hit movie *Le Fabuleux Destin d'Amélie Poulain* (Amélie from Montmartre). Forget Toulouse-Lautrec and the Moulin Rouge: Montmartre today is in the throes of Amélie mania. "She has seduced the public," says Alain van Genep, director of operations for France's largest theater chain, Union Générale des Cinémas, which helped bankroll the film.

The pixie-faced Amélie, played by newcomer Audrey Tautou, has also drawn record audiences into French theaters. The romantic comedy has sold more than 7.3 million tickets since it opened in April. Box office receipts total \$37.7 million so far, more than three times the film's price tag. Indeed, *Amélie* is one of four French films released this year that have sold more than 5 million tickets apiece, beating a record set in 1947.

NEW WAVE. The hits have inspired talk of a renaissance in the \$813 million French film industry, long used to playing David to Hollywood's Goliath, even at home. Revenues are expected to grow by another \$37 million this year, and French flicks are trouncing the American competition for the first time in nearly 20 years.

The French film industry is certainly wising up. Gone are the navel-gazing *ménages-à-trois* that have become the stereotype of French cinema. In their place are a wide variety of American-style genre films—from action adventures to gothic dramas—churned out by a wave of young directors, many of whom have worked in the U.S. "French cinema has been seen as elitist, appealing more to cinephiles," says David Kessler, director of the National Cine-

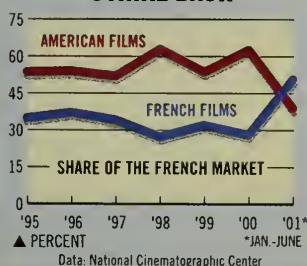
matographic Center. "Now, we're able to reach a larger public."

It helps that the new French films have bigger budgets and better production values. Take *Le Pacte des Loups* (Brotherhood of the Wolf), a medieval knight's tale that in January logged the biggest opening day for a French film this year. The movie boasted a \$28 million budget, compared with the \$4.2 million that is the average for most French flicks. "We wanted people to say: 'Damn, the French are capable of making something like that!'" says Richard Grandpierre, whose company, Eskwad, co-produced the film with Studio Canal, a division of Vivendi Universal.

The question now is whether such



FRENCH FLICKS STRIKE BACK



CHARMING

The romantic comedy *Amélie Poulain* has sold a record-breaking 7.3 million tickets

movies will help France regain some of the global cinematic prestige it enjoyed in the 1960s. Most French films will probably still enjoy limited success in the U.S., because of the language barrier. But one or two breakaway hits are now possible. "If one foreign movie makes it this year, it will be [*Amélie*]," says Agnes Mentre, executive vice-president for acquisitions and co-productions at Miramax, which is readying the movie for U.S. distribution. The residents of Montmartre better brace themselves for those American film buffs, too.

By Christina White in Paris



NEC'S NISHIGAKI:
*Leading Japan's
restructuring wave*

JAPAN

UNDER THE KNIFE

The global tech crunch forces chip giants to pare down

When Koji Nishigaki became CEO of NEC Corp. 2½ years ago, Japan's top chip- and computer maker was in trouble. Nishigaki knew he'd have to impose drastic measures. And by Japanese standards, he did. Nishigaki cut NEC's workforce by 15,000, or 10%. He streamlined management, unloaded some unprofitable businesses, and introduced the kind of transparent decision-making that is as rare in Japan as shareholder value.

End of story? More like a work in progress. Nishigaki now has to find dramatic new ways to cut costs—fast. Two years ago, he was fighting the effects of Japan's slowdown. Now, he's feeling the heat from a global tech recession. As a result, NEC finds itself sitting on piles of

unsold memory chips. "This IT recession is so tough," he says, "it's forcing us into another round of restructuring."

Nishigaki has plenty of company. Since he announced another series of deep cost cuts in July, Toshiba Corp. and Fujitsu Ltd. have unveiled their own restructuring plans. Like NEC, they are seeing a

scary drop in demand for a wide range of info-tech devices. These diversified giants are usually able to cushion losses in one area with gains in another. But now, they've been hard hit by a simultaneous slump in chips, computers, cell phones, and telecommunications equipment. NEC, Toshiba, and Fujitsu are all expected to post losses this year.

The question is, do their restructuring plans go far enough? On paper, they seem impressive (table), but analysts say Japan's electronics makers are focusing on cutting costs when they should be reinventing themselves. Right now, they make everything from hard-disk drives to submarine cables. "CEOs should be asking themselves: 'Which businesses should I focus on to win? Which business should I exit altogether?'" says Michael Garstka, a vice-president at consultant Bain & Co. in Japan.

If the giants do manage to fix themselves by cutting divisions as well as jobs, investors and lenders will favor them at the expense of other Japanese industries, which will feel pressure to pare down, too. "This is the start of a restructuring wave that could spread to other sectors," says Merrill Lynch & Co. senior analyst Hitoshi Shin. Such

protected industries as banking, retail and construction all need to slim down.

Many eyes will be on NEC's Nishigaki as a leader of the restructuring drive. No one in the IT industry has worked harder to revamp his company. Nishigaki was the first to forge joint ventures with Japanese rivals—a memory chip alliance with Hitachi Ltd., and one with Matsushita Electric Industrial Co. (Panasonic) to develop next-generation cell-phone software. That will free up resources to develop value-added businesses, including system chips for cell phones, autos, and game machines.

TOO LITTLE? Sounds good, but analysts are clamoring for more. "I think there has to be a more drastic restructuring of chip operations, for starters," says Yoshiharu Izumi, an industry analyst at UBS Warburg in Tokyo. NEC currently operates nine chip-manufacturing plants, seven of them around Japan. Samsung Electronics, by comparison, operates two worldwide—one in Korea and another in the U.S. Nishigaki will sell off some plants to contract manufacturer and convert others to system-chip production. But he's not about to pull out of chip production altogether.

If the prospects for NEC are less than bright, they're downright gloomy for Fujitsu and Toshiba. Fujitsu President Naoyuki Aikusa hopes to transform his company into a global software-and-services provider along the lines of IBM. But Fujitsu has made little progress in capturing market share in Europe and the U.S. despite heavy investment. Toshiba President Tadashi Okamura grabbed headlines with his announcement of major job cuts. But he failed to point out where Toshiba, heavily reliant on chip and notebook-PC sales, will find its next growth engine. "This is low level restructuring," scoffs Merrill Lynch's Shin. "They're mistaken if they think they'll return to profit just by cutting costs." What's required for Japan's fabled electronics titans is nothing less than a wholesale makeover.

By Irene M. Kunii in Tokyo

Where They'll Cut

Japan's top electronics groups have big plans for restructuring

NEC

- Eliminate 4,000 chip-related jobs, 2,500 of them in Japan, with more reductions to follow
- Pull out of the memory-chip market by 2004
- Revamp PC and display units and hike investment in broadband and mobile networking

TOSHIBA

- Reduce workforce by 10%, or 18,800 jobs, 17,000 of them in Japan, by March, 2004
- Cut procurement costs by 20% and reduce by half the number of suppliers from today's 6,750
- Spin off its money-losing memory-chip operations

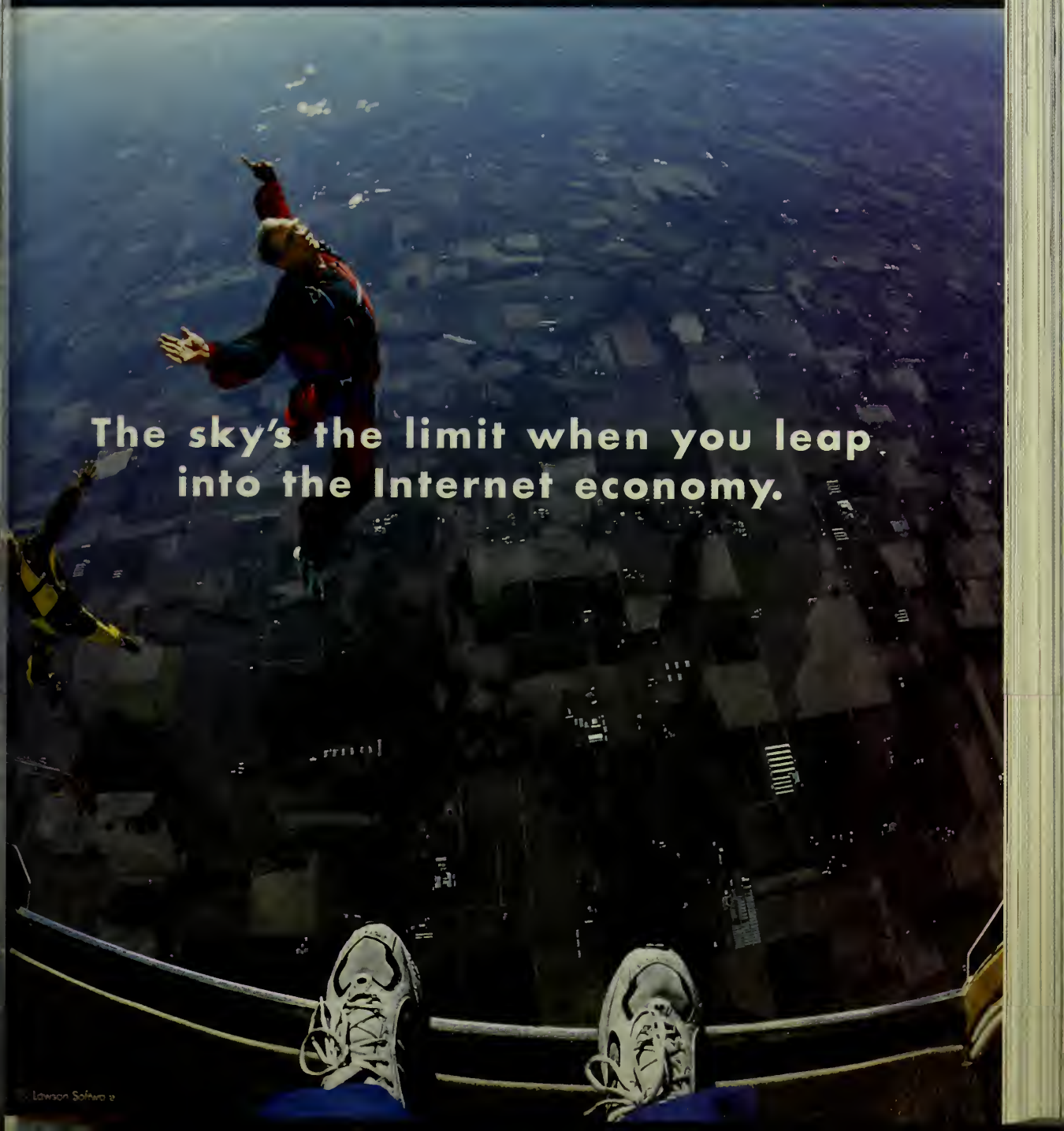
FUJITSU

- Slash 16,400 jobs, 5,000 of them in Japan, by March, 2002
- Merge 12 domestic chip-fabrication lines into 9, and consolidate assembly and component plants in Japan
- Reduce hardware operations to focus on software and services

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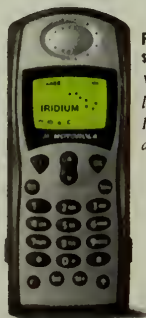
DR. RONALO SHEMENSKI

*Rescued from the South Pole,
Wednesday, April 25, 2001.
Iridium kept the lines of
communication open
through the entire effort.*

The darkness goes on and on. Radios are mostly useless. And the air is so cold, it can turn a plane's hydraulic fluid to jelly. But if the doctor didn't get out before winter really closed in, his gall stones could have returned with fatal consequences. So when the third rescue attempt took

off in late April, the team counted on Iridium to keep their lines of communication open. It's the only system

capable of sending and receiving voice and data globally. Actually, Iridium helped the good doctor twice. Weeks earlier, he used it to contact the Denver specialist who helped diagnose his condition. To learn how Iridium can be there for you, simply call 1-866-947-4348 toll-free, or visit our website.



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WILL TOKYO EMBRACE ANOTHER MOUSE?

Disney's second park is facing a swarm of challenges

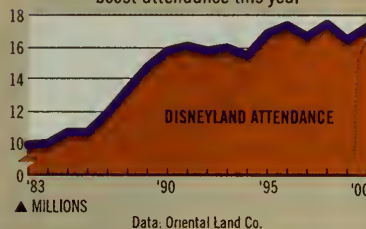
It features a choreographed parade of floats, a Pacific Island volcano, sea-salt flavor ice cream—and, of course, the world's most famous rodent. Welcome to Disney & Co.'s big second act in Japan. On Sept. 4, Disney and its Japanese partner, Oriental Land, threw open the gates to DisneySea, a \$2.8 billion marine-themed attraction built right next door to Tokyo Disneyland, which opened in 1983.

Disney and Oriental Land are betting that Mickey Mouse in an admiral's uniform will lift Disney's Tokyo fortunes. Attendance at the original park peaked in 1998 (chart), and daily spending per guest, while still the highest of any Disney park, slid 5% over the last two years, after a 13-year streak of gains. In May, Oriental Land reported that group net profit fell 52.2%, to



MICKEY FATIGUE

Disney hopes its new Tokyo park will boost attendance this year



SAFE PASSAGE

DisneySea profits will hinge on how pressed consumers feel as the economy deteriorates

\$395 million, for the year ended in March, despite a 15% gain in sales, to \$1.7 billion. "Over the past decade, Tokyo Disneyland has managed to shield itself from [Japan's ailing] economy," says Hiroshi Okubo, an analyst in the Tokyo office of UBS Warburg. "But the drop in guest spending suggests those days may be ending."

Disney needs to goose receipts in Japan because it wants to show the Mouse franchise is alive and well even as U.S. parks struggle to attract visitors. Disney and Oriental Land expect both Japanese parks to host a combined 25 million visitors a year, up from the current 17.3 million for Tokyo Disney-

land alone. Tokyo-based Mitsubishi Research Institute Inc. estimates that Tokyo DisneySea will generate \$15 billion a year in economic activity, if one includes such related businesses as area malls, gas stations, and support services. For its part, Disney, which put up a paltry \$20 million for basic pre-

assuring. For example, the company's surf-and-sand-themed California Adventure park is right next door to the original Disneyland in Anaheim, Calif. It has failed to generate the anticipated traffic. Not a problem in Tokyo, asserts Oriental Land. It says Tokyo DisneySea will act as a catalyst, increasing the number of visitors to both parks and how much they spend on mouse-ear caps and gourmet popcorn. "We're confident that guest spending levels have bottomed out and will pick up from here on out," says company spokesman George Yasuoka.

BOOZE AND BACKRUBS. The key is to make DisneySea sufficiently different from its neighbor. Oriental Land is pitching it to a slightly older, more male clientele than the original park, where about 70% of guests are female, mostly 20- to 30-year-olds—some with kids, others with dates or girlfriends. DisneySea offers booze, a hair-raising roller coaster ride in a mock Incan temple, and an on-site spa. Visitors can even get married in the park.

But DisneySea faces other challenges. As the economy sinks back into recession, Japanese may become hesitant to pay the \$46 entry fee. And there's the increasing competition. In March, Universal Studios Japan opened in Osaka. The \$1.4 billion movie-theme park is a potential threat because it offers residents of western Japan a closer alternative than Tokyo Disney.

Still, thanks in part to field trips that introduce legions of kids to Mickey and his friends, the Disney experience has become ingrained in Japanese life. In his 1993 book, *Disneyland as Holy Land*, University of Tokyo professor Masako Notoji wrote: "The opening of Tokyo Disneyland was, in retrospect, the greatest cultural event in Japan during the '80s." Or at any rate the most profitable. The \$2.8 billion question is whether DisneySea can engender similar enthusiasm—and keep the turnstiles spinning.

By Chester Dawson in Tokyo



construction design work, gets about 10% of the gate, 5% of food and merchandise sales, and 10% of corporate sponsorships.

While advance tickets for the grand opening sold out in hours, some wonder if DisneySea will live up to all the hype. One fear is that it will cannibalize visitors from the original park. Disney's record of adjacent attractions is not re-



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EDITED BY ROSE BRADY

TAIWAN: WHY CHEN MAY BUILD NEW BRIDGES TO CHINA

His presidency has been little short of disastrous. Since his election in May, 2000, Taiwan's Chen Shui-bian has presided over the island's worst economic crisis in decades. The opposition Kuomintang (KMT) party has stymied his key initiatives in the Taiwan legislature. And Beijing has steadfastly ignored his gestures toward reopening cross-strait talks, which have been stalled since 1998, while pointing increasing numbers of missiles at the island.

Now, Chen, 50, is making a near-desperate bid to turn his political fortunes around before key legislative elections in December. His Democratic Progressive Party controls only 77 seats in the 225-seat legislature and will be lucky to maintain that position—especially given widespread discontent with the economy. Taiwan's gross domestic product is expected to contract this year for the first time in 49 years, and unemployment is rising. So, in an important move, the pro-independence Chen promised on Aug. 27 to heed the recommendations of a blue-ribbon panel and push for expanded travel, trade, and investment ties with the Chinese mainland. The proposals are meant to boost the economy and appease Taiwanese who want closer relations with the mainland. Taiwanese companies figure their only chance for growth is to turn to the mainland's cheap production base and grab a larger chunk of the mainland's giant market.

FIRST STEP. If the proposals go ahead, they would represent the biggest change in cross-strait relations since Taiwan adopted the "go slow, be patient" policy toward economic contacts with China in 1996. Yet Chen is caught between the hard-line pro-independence stance of his DPP and a recalcitrant leadership in China. Beijing has refused to negotiate with Chen unless he endorses the One China policy that states that Taiwan is part of China. Chen's only choice is to steer a narrow course through these shoals. He seems intent on

boosting ties with the mainland step by step, but he's likely to stop short of embracing the One China policy. "Chen is showing more pragmatism," says Philip Yang, associate professor of political science at National Taiwan University.

As a first step, Chen is likely to lift the \$50 million cap on investments allowed by Taiwanese companies on the mainland. That is sure to please Taiwan business, which has quietly invested an estimated \$60 billion in China over the past decade. Chen will also make it easier for mainlanders to get visas to travel to Taiwan. But if Beijing continues to refuse to negotiate with Chen on direct air shipping, and postal links, there's not much more he can do unilaterally to boost ties.

The embattled President hasn't given up. He's trying to use the economic panel to break the legislative gridlock that has held him back since his election. Chen assembled the committee himself, inviting representatives from government, academia, business, and opposition parties to take part. That's an effort to ensure a broad base of support as he moves forward with the panel's proposals. Chen also wants to boost the DPP's power base in the legislature after the December elections by teaming up with members of opposition parties. One party eager to work with him is the new Taiwan Solidarity Union, founded by KMT defectors and backed by former President Lee Teng-hui. But Chen must be wary of aligning himself with the adamantly pro-independence Lee, for fear of incensing Beijing. Does Chen have a real chance of turning his presidency around? His popularity rating shot from 30% to 45% after he agreed to the economic panel's proposals in late August. But Chen still faces a political minefield in dealing with Beijing and his domestic rivals. It is going to be a long, hard three years until he faces reelection.

By Frederik Balfour in Hong Kong



CHEN: In political trouble

GLOBAL WRAPUP

SOLIDARITY: ON THE WAY OUT?

► The embarrassing ouster of Finance Minister Jaroslaw Bauc on Aug. 28 couldn't have come at a worse time for Poland's unpopular Solidarity government. It shows that Prime Minister Jerzy Buzek's Cabinet is in total disarray just 3½ weeks before the general election on Sept. 23. Buzek says he sacked Bauc, a nonparty technocrat, for failing to warn him early enough that Poland is on the brink of a budget crisis. Political analysts in Warsaw say Bauc's dismissal will give the opposi-

tion Socialists, who were already expected to trounce Solidarity in the poll, plenty of ammunition to lob at the government as campaigning reaches its peak. It's now virtually certain that the Socialists will lead the next government, they say.

SPAIN CRACKS DOWN

► A growing flood of economic refugees is undermining Spain's relations with Morocco—and creating tensions along Europe's southern border. In late August, Spanish police, working under a tight new immigration law,

rounded up more than 1,000 Moroccan immigrants along the Spanish coast. At least 20 others drowned in August trying to cross the Strait of Gibraltar in rickety boats.

Angered by Madrid's tough new line, the Moroccan government has revoked a fishing agreement. Spain has cut back aid to Morocco. As the governments exchange recriminations, tensions mount. Moroccan shoppers in Spain's north African outpost of Ceuta threw bottles and rocks at Spanish police on Aug. 28. The police dispersed the crowd by unleashing smoke bombs.



STORAGE

EMC DISHES OUT A LITTLE MORE TLC

As times get tough, the hard-driving data-storage outfit has been softening its sales approach

Kurt Wong never read EMC Corp.'s sales bids from front to back. The data-storage outfit's typical 50-page pitch was so much longer than other bids that Wong, director of storage engineering at Visa International, would skip to the last page, to the price, which was always two to three times as high as the lowest bid. When EMC realized that Wong was ignoring its marketing spiel, it started burying the figure in the middle of the proposals. Even more irritating was the accompanying arrogance. "It was a take-it-or-leave-it attitude without directly saying so. Like: 'You're stupid if you don't take

this,'" says Wong. Still, take it Wong did. At that time, EMC was miles ahead of its rivals in storage technology.

Not anymore. Competitors IBM and Hitachi Data Systems are offering storage systems that are just as good as EMC's. And customers are only too happy to switch to rivals that can offer reliable storage for a reasonable price—without the high-handed attitude. Wong, for instance, bought storage from IBM last year for the first time in several years. Big Blue now supplies about 25% of his storage systems, up from next to nothing a year ago, while EMC's share has dropped from 80% last year to 60%. Hannaford Brothers Co., a supermarket chain in Scarborough, Me., bought from IBM in December for the first time in eight years. "[It] was less expensive, had better performance, and was easier to manage," says Bill Homa, Hannaford's chief information officer. "[EMC

'I HATE ARROGANCE'

Tucci admits that EMC was too cocky in the past. "It's the old rule: Treat others how you want to be treated"

is] facing real competition for the first time in years."

The change couldn't have come at a worse time. With the collapse of many dot-coms and telecom companies, the storage market is expected to be flat this year, at about \$30 billion, compared with 16% growth last year, according to market researcher Gartner Dataquest. That has EMC fighting off a growing number of rivals just as the market is stagnating. The double whammy is taking its toll: EMC, which had been growing at an average annual clip of 37% since 1995, posted its first year-over-year revenue decline in 48 quarters in the period ended June 30. Revenues slid 6% in the second quarter, to \$2.15 billion, while net income dropped 75%, to \$109 million. EMC's stock has plummeted to \$17—off more than 80% since

its September, 2000, peak.

Now, Joseph M. Tucci, who took over as chief executive from longtime CEO Michael C. Ruettgers in January, is shaking things up. His biggest challenge: getting a company that has a long tradition of going it alone to work more effectively with others, including its customers, companies that resell its products, and even its rivals. For example, he wants to sell more storage products through resellers to lower overhead, which ballooned to 31% of revenues in the second quarter, up from 24% a year earlier. That means the direct-sales force, which used to try to swipe business from resellers, needs to cooperate with companies such as Eastman Kodak Co., which sells EMC's storage to hospital X-ray departments along with Kodak imaging equipment. To accomplish that, EMC sales reps now receive fatter commissions than they used

to get if they sell through a partner.

The cooperation won't end there. Tucci wants EMC services, such as consulting on storage systems, to increase to 20% of revenues in 2003, up from 7% last year. To get there, EMC will sell its services alongside tech consultants, such as Electronic Data Systems. And, in a dramatic break with past practices, EMC is starting to make software that will drive the storage gear of competing hardware makers for the first time. The first software program, which lets a customer coordinate storage cabinets from a variety of hardware companies from one control center, was introduced a few months ago. This initiative requires EMC programmers to work with rivals to make sure EMC's software runs on their hardware smoothly.

FINE LINE. Tucci is trying to infuse EMC's culture with a dose of humility. He's coaching the sales staff and other employees to drop the smugness that alienated customers like Wong. He's also reducing the number of accounts salespeople handle and cutting their quotas to encourage them to spend more time with big customers. "It's the old rule: Treat others how you want to be treated," he says. The company has even fired people who get too cocky. "You've got to weed out the rotten ones," Tucci says. "I hate arrogance. I just hate it."

The trick will be to change EMC's culture just enough to hold on to its customers without losing the aggressive spirit that made the 22-year-old company the leader in the storage market. For example, EMC needs to walk a fine line between selling its software widely and giving away the technology that makes its products unique. "On paper,

it's the way to go," says analyst James D. Poyner Jr. of C.E. Unterberg, Towbin. "Politically, it may be difficult."

Tucci, who joined EMC in January, 2000, and became CEO a year later, may be just the person to revamp EMC. Born in Brooklyn, N.Y., he graduated from Manhattan College and got an MBA from Columbia University. In 1993, he led Wang Laboratories Inc. out of bankruptcy and transformed the company from a hardware seller into a software and services provider. In 1999, he sold Wang to Getronics, a Dutch tech-services company, netting a cool \$2 billion for his shareholders. Ruettgers spent four months recruiting him to EMC because Ruettgers felt no exec inside EMC had the experience to run the company. In his first 90 days, Tucci built the foundation for EMC's consulting business, which is becoming a substantial revenue producer.

Tucci has proved his toughness in personnel matters too. In April, he moved Mike Ruffolo, the head of sales, services, and marketing, into an internal consulting job because Tucci felt the business wasn't clicking. He gave responsibility for sales and services to Frank M. Hauck, an 11-year EMC veteran who had never sold a storage box—but had built up a world-class service

The storage market is stagnating, and EMC is facing a slew of fierce new rivals. As a result, sales and profits are down, and the stock has tumbled 80%

network. Ruffolo left in July to join Akamai, an Internet company. "When your team is not doing what you want it to do, you just make changes," says Tucci.

Changing the culture at EMC will take more than a little turnover in the executive suite. The company has fostered a hyperaggressive environment. One way it has done that is by filling its sales ranks with blue-collar men who played sports. Each year, the top execs pumped up the sales team at a pep kickoff in January. At one, the executive team showed clips from the movie *Apollo 13*. The scene: The chief NASA engineer puts a bunch of engineers in a room and gives them some parts to find a way to bring

the astronauts home alive. The message became a mantra at EMC: Failure was not an option. "If 6,000 people are being told failure is not an option, not an option, not an option right up to the end they say: 'I'm going to figure out how to do this,'" says a former EMC executive. "The culture just doesn't look at reality. It can't see reality."

Some analysts suggest that that culture blinded management to the tech downturn and hurt its credibility on Wall Street. As other tech companies ran into troubles earlier this year, EMC

NEW BOSS, NEW PLAN

Tough times have forced storage giant EMC to change its ways. Here's how its new CEO, Joseph Tucci, is trying to overhaul the business:

LOSE THE SWAGGER

In the boom years, EMC charged more than rivals—and treated customers as if they were lucky to get EMC gear. Now, as demand dries up, Tucci & Co. are pushing a humbler approach. They're coaching salespeople to be nicer and reducing the number of accounts that reps handle so they can offer better service.

USE THE CHANNEL

While EMC's direct-sales force used to compete aggressively against partners that sold EMC gear, Tucci now wants to emphasize selling through partners to lower expenses. But it's not clear that the resellers that got beat up by EMC's sales force for years will become strong advocates for the company.

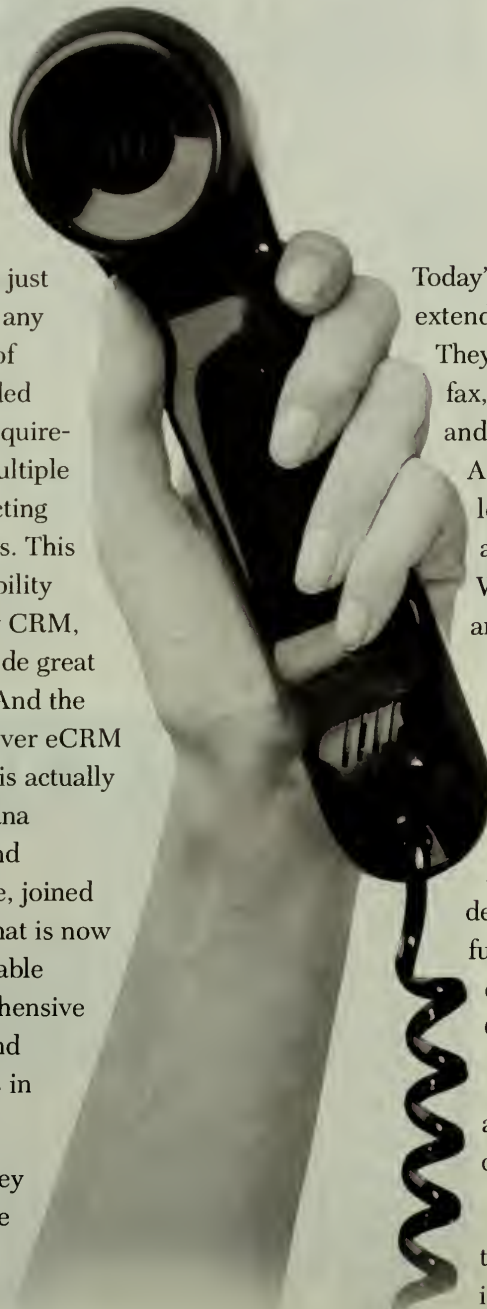
SELL THE SOFTWARE

EMC used to sell its storage software only with EMC hardware. Now, Tucci plans to offer software to customers who will use it with hardware from rivals. The goal is for software to contribute more than 30% of revenues in 2003, up from 16% last year. Selling software alone, however, may erode EMC's competitive advantage.

BUILD UP SERVICES

Services, such as consulting on storage systems, made up 7% of EMC's revenues in 2000, and Tucci wants to boost that to 20% by 2003. To get there, he's upping the services staff by 50%, to 2,000, in the next year and is recruiting more partners to help offer a full range of services.

The merger that creates great customer service



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execs remained upbeat about the company's performance. Back at the beginning of the year, they insisted EMC would boost revenues 25% to 35% from the \$8.9 billion last year. In April, EMC lowered the revenue growth guidance, but only to 20%. It wasn't until July that the company conceded it didn't have a clue how it would do for the year—months after other tech companies. "They tend to have a view that there's no reason they shouldn't be able to cause something to happen," says analyst Laura Conigliaro of Goldman, Sachs & Co.

EMC insists that it's changing. Besides giving salespeople fewer accounts and lower quotas, managers are visiting customers with reps to help close deals. "It's a little bit more teamwork," says Hauck. Customers are beginning to notice the change. Visa's Wong, for example, says he's getting more TLC from the company these days. EMC assigned him a special account manager so Visa doesn't have to compete for attention with other accounts. "He's very good," says Wong, although he won't say whether he'll give EMC more business.

"CAN WE HELP?" Stephen Bold may be a prototype of the more accommodating EMC sales rep. The avid golfer and weight lifter now drives his used Mercedes to just three accounts outside Boston, down from nine last year. The other six accounts have been passed to another member of EMC's 6,000-person sales force. Bold can't seem to do enough for his clients. A huge opportunity looms at telecom carrier CTC Communications Group Inc., based in Waltham, Mass.: a new data center the company will use to provide storage services for customers. "Challenge us," he tells Jeffrey C. Lavin, vice-president for marketing at CTC. "Just let us know what you need." The message is the same at Tufts Health Plan, another major client. "Can we help?" Bold asks one morning in August, as Robert Bimmler, a systems manager at Tufts, recounts how he's under more pressure to better justify tech spending.

Back at the office, Bold makes a phone call to arrange the catering for an upcoming Saturday softball game. Techies from EMC's Internet Services Group are playing their counterparts at Staples. Will EMC be nice and let the customer win? "No," says Bold. "We play to..." He stops abruptly. But he clearly means to say win. EMC hasn't lost its drive. It's just toned down the swagger that used to go with it.

By Faith Keenan
in Hopkinton, Mass.

UPSTARTS

IS TiVo's SIGNAL FADING?

After a strong start, the TV-recording service is in trouble



For months, TiVo Inc. hoped to hook late-night talk show host David Letterman. Celebs from Rosie O'Donnell to Howard Stern had become converts to the company's nifty gadget. And why not? It seemed straight out of *Star Trek*, allowing customers to pause live TV, skip commercials, and automatically record favorite programs. Letterman, though, showed little interest in trying TiVo's "personal video recorder" until a guest raved about it on his show. Within days, he had one and began talking it up, too. "You can't buy that kind of advertising," crows TiVo CEO Michael Ramsay.

Trouble is, all the celebrity buzz in the world might not do the trick for TiVo. Despite an early lead in the personal video recorder business, as well as critical accolades for what the company

calls "time-warping" technology, TiVo is fighting for its life. The company will drain its \$50 million cash reserve by Feb. 1 unless it can find takers for a \$7 million private stock offering it launched in July. Even then, it must at least triple its 225,000 subscribers to break even. What's more, TiVo will have to fend off new, deep-pocketed competitors, including Microsoft Corp., and enforce patents on its technology—all while keeping potential suitors such as AOL Time Warner Inc. at bay. "Yes things have melted down, but we're in this for the long haul," Ramsay says.

So far, though, TiVo has played more for the short term. In fiscal 2001, ended in January, the company spent \$100 million on sales and marketing, or a staggering \$735 for each new customer it acquired that year. With a business model built around expectations it would



MIXED MESSAGE

Co-founders Ramsay and Barton invented a technology people love, but sales lag expectations

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Information Technology

have cash to burn from bullish investors, TiVo ran tongue-in-cheek television commercials. These boosted its profile, but the marketing message was too muddled to explain what its technology could do for people—such as finding and recording any show starring, say, Pee Wee Herman. Now, TiVo's fiscal 2002 marketing budget has been slashed to \$13 million and execs are hoping to gain subscribers through word-of-mouth endorsements—a tricky maneuver given the number of customers it needs. "The good news is, people who are TiVo subscribers love it. The bad news is that growing that number is proving a bigger challenge than we thought," laments board member Geoff Yang, whose venture-capital firm, Redpoint Ventures, was an early backer.

FALLING SHORT. TiVo's problems are yet another reality check for new technology companies. What looks good on paper can turn to dust if consumers don't catch on. PVRs (personal video recorders) were billed as the technology that would deal a deathblow to TV advertising and a mass culture built around prime time by letting people watch TV whenever they wanted without ever having to lay eyes on a commercial. But America's couch potatoes seem to be on another channel: So far, they have snapped up only 700,000 recorders, far short of the 3 million Forrester Research Inc. predicted would be sold by the end of this year.

Ramsay and co-founder James M. Barton knew it would be a tough slog. The two former Silicon Graphics Inc. execs got together in the early 1990s while collaborating with Time Warner Inc. on an interactive-TV trial in Orlando. From that experiment—which ultimately failed—they dreamed of a box that could navigate the flotsam of TV. They founded TiVo in 1997, warning their Who's Who list of investors—including AOL, NBC, Disney, Sony, and major cable operators—that it would take time for the idea to catch on.

More than \$300 million in losses later, it still hasn't. The company generated only \$3.6 million in revenues for its fiscal year 2001, while losing \$206 million. For fiscal 2002, analysts expect TiVo to lose \$163 million on sales of \$21 million, according to a survey of analysts by First Call/Thomson Financial. The company's stock is at about \$5.50 a share, down more than 90% from its peak of \$71.50 in January, 2000.

Part of the company's problem is pure economics. A TiVo box—a receiver with a spacious computer hard drive for storing shows—ranges in price from \$300 to \$600 from makers Sony Corp. and Philips Electronics. To make the box work, TiVo sells software and a program guide that let customers record selected shows—for either a onetime cost of \$249, or \$9.95 a month. The double whammy in fees is about what rivals charge, but it's too much for many consumers, who can buy a VCR for \$49.

TiVo's TRAVAILS



TiVo's service, which stores TV programs for later viewing, has won wide praise. But the company is struggling to reach profitability. Here are the hurdles it faces:

CASH Even with \$50 million in the bank, TiVo needs more funds. Otherwise it will likely run out of money by February. That's 10 months before it expects to reach the breakeven level of 700,000 subscribers—triple today's level.

COMPETITION Deep-pocketed rivals are wooing consumers. Microsoft is spending \$50 million to promote UltimateTV, which is similar to TiVo. Satellite-TV provider EchoStar is offering a similar service to its 6 million customers. And in August, SonicBlue bought rival ReplayTV.

CUSTOMERS Last year, TiVo spent \$735 in marketing costs for each new subscriber. To save cash, TiVo is trimming ad budgets. That could backfire as consumers rein in spending.

CONTRACTS TiVo owns patents for much of the technology used by both it and competitors. The company wants rivals like Microsoft and EchoStar to pay licensing fees but may not have enough money to take them to court.

Now, Ramsay and Barton are scrambling to keep TiVo afloat. To conserve cash, TiVo in April laid off 80 of its 350 employees. To shore up sales, it has persuaded Philips to offer entry-level boxes for \$199. The company has a deal with DirecTV Inc. that gives it the potential of reaching the satellite-TV provider's 10 million subscribers. While customers of both services still must pay TiVo's \$9.95 monthly fee, the two offer a combo satellite receiver and PVR for a mere \$299. And TiVo hopes to clear up its marketing message in a 30-minute DirecTV-only infomercial showing how the PVR works, with vignettes on how it adds

value to the TV-viewing experience.

Competitors are ready to pounce on any weakness at TiVo. On Sept. 5, SonicBlue Inc., the maker of the popular RMP3 player that bought troubled rival ReplayTV Inc. last month, will unveil a new ReplayTV box starting at \$699—the first to allow consumers to both download and share video and pictures through high-speed Internet connections. And then there's Microsoft. The software giant is spending \$50 million this year to make a market for itself in PVR.

Leveraging Microsoft's older WebTV technology, its \$399 UltimateTV box offers e-mail and Web surfing. This fall, Microsoft plans a torrent of television and print ads and in-store demonstrations to push the benefits of PVRs and outflank its rival. "TiVo hasn't shown you what a PVR is and why you'd want it. We plan to," says Mar Mullen, director of strategic planning for UltimateTV. Ramsay scoffs at the challenge. "There's a learning curve here" that Microsoft will have difficulty climbing, he says.

PATENT PAYMENTS. One potentially bright spot is the company's intellectual property. In May, TiVo was awarded patents for many of the fundamental aspects of the technology that makes PVRs different from VCRs. Ramsay says those patents could generate up to \$27 million in licensing fees in fiscal 2003—on top of the \$40 million in other revenue the company is expecting. Problem is, TiVo may be forced to burn cash if it needs to sue to get rivals such as Microsoft to pay up.

Even with the patent money, some analysts wonder whether TiVo can remain independent. AOL already owns 13% of the upstart through a \$200 million investment made to co-develop its next-generation AOLTV service due next year. AOL has options to purchase up to 30% of TiVo, but analysts say it could gobble up the entire company. Indeed, Forrester analyst Josh Bernhoft bluntly says AOL should snap up TiVo. He argues that the proprietary technology would prove a compelling feature for AOL's cable subscribers, who could then use the machine to store downloaded movies, music, and games. AOL declines to comment on its plans for TiVo. Ramsay confidently predicts TiVo can survive its challenges alone. But unless he can find customers and money quickly, TiVo may become just another footnote in the history of the boob tube.

By Cliff Edwards in Alviso, Calif.



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THE RESOURCE FOR ENTREPRENEURS

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On a Tear

Joey Tomko shows off some of the \$15,000 in freebies he piled up with points earned from using his business credit card



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A bumper crop of new credit cards for small business has created a feast of low rates, lower fees, and free goodies. Here's a guide to the best deals

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Big companies are always trying to push around small partners. But some entrepreneurs are pushing back in court—and winning huge awards



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Microsoft and Oracle both want to be your host. Which has the better Web-based apps for small business?



SOAPY SALES
The Nashes knock on your bathroom door (page 12)

Cover photograph by Timothy Archibald

SMALL BIZ
ONLINE

Hope vs. Doubt

Most entrepreneurs foresee an economic rebound this year. Yet they've corked capital spending. Two-thirds won't spend on computer equipment and 76% claim they won't develop facilities, says Dun & Bradstreet's new survey.

DSL Dominoes

August brought more DSL disasters. Rhythms NetConnections Inc. filed for bankruptcy and said it would terminate service. Covad Communications Group Inc. announced plans to file for bankruptcy but offered rebates to Rhythms customers who switch to its service.

Venture Losses

When the tech bubble burst, so did the venture-capital industry's returns. For the first time, portfolios recorded a loss, down 6.7% for the year ended Mar. 31, 2001.

For the full stories, visit smallbiz.businessweek.com

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iNBOX

EDITED BY NAWEEN A. MANGI

The Doctor Is In

VIRUS EXPERTS ARE GIVING SMALL BIZ BIG BREAKS

AFTER A SUMMER OF CYBERPLAGUES, you have to wonder: Can your company fight off the Code Red worm that defaces Web sites, or the demonic Sircan virus that e-mails your files to people in your address book? If not, expect trouble. By 2004, cybercrime will create "economically significant losses" for more than half of small businesses, says Bill Malik of Gartner Inc. in Stamford, Conn.

Luckily for you, the tech downturn means network security consultants are underemployed—and **THEY'RE ALL CUTTING FEES** to win business from small companies. Also, antivirus software options like Norton's AntiVirus Corporate Edition 7.5 for Small Business (\$384.95/ten computers) and McAfee's Virus-Scan ASaP (\$468/ten computers) come with **INCREASINGLY EFFECTIVE UPDATES**—downloaded automatically—to ensure you're protected against each new virus. "Sure, protection costs money," says Malik. "But so does a lock on a front door."

SO THEY SAY

"My next company is not going to have employees."

LESLIE SEGAL, *TestWare Associates*, on dealing with employee morale (page 5)

ONE IOTA

FOCUS GROUP:

Percentage of serial entrepreneurs with Attention Deficit Disorder, vs. 5% for the total population

Data: The Stockholm School of Economics

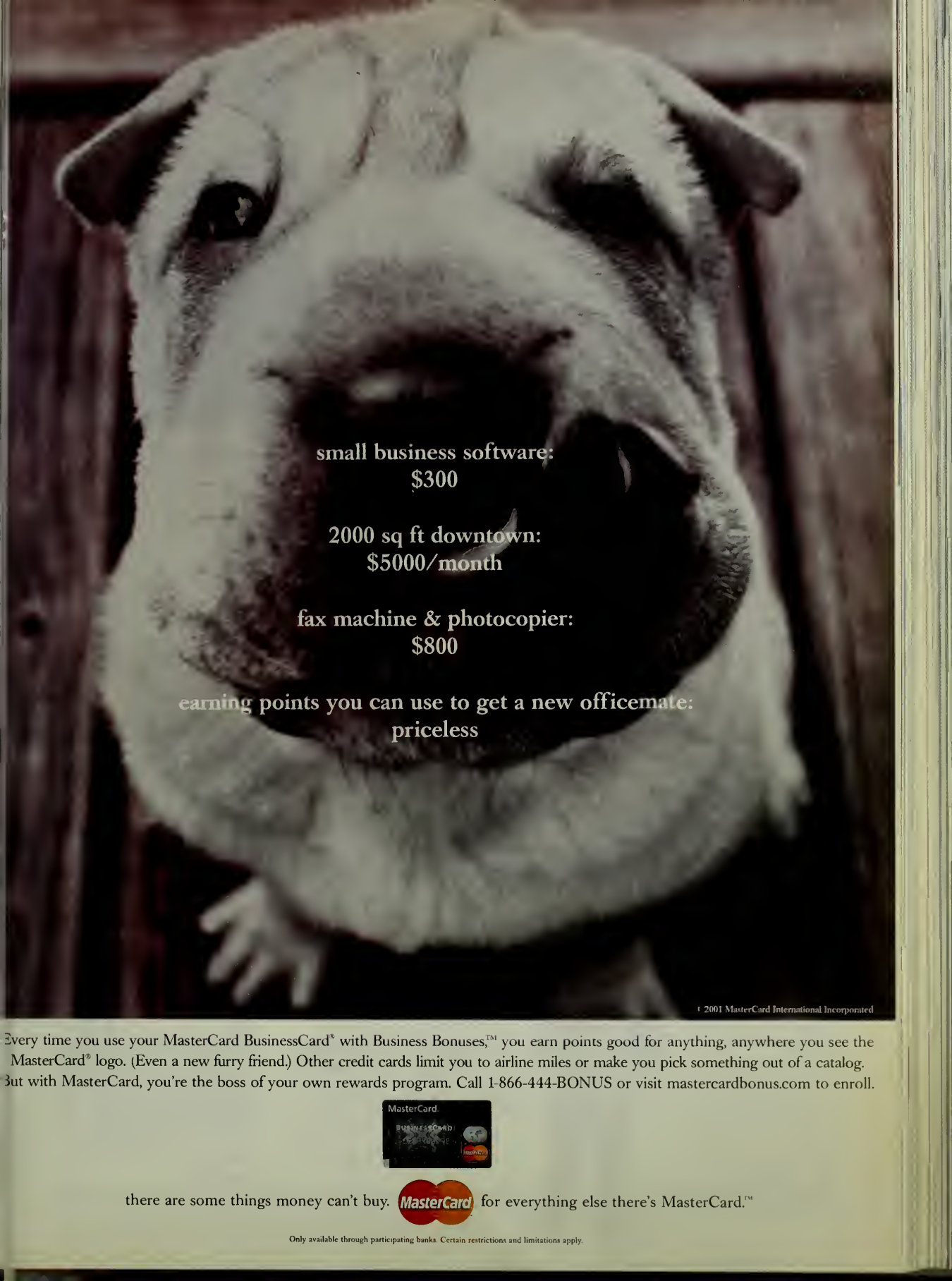
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A Pan-Asian Shopping Spree

Looking to import exotic Thai handicrafts or leather upholstery from India?

AsianVendors.com, an India-based portal launched in June, has info on 3,000 vendors who sell 17,000 products in seven Asian countries. An importer can find silk rugs to children's apparel on the site—and search for it free of charge.





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SOUND BITES

David Behnke, managing director, J. P. Morgan Chase, on **SELLING YOUR BUSINESS**

What should entrepreneurs consider before they begin the sale process? Think about timing. If something is about to happen that will increase the value of your company, then hold off. And consider your objectives. Do you want the highest price or the right to retain a stake in the company? Do you care if key employees stay on?

How should you evaluate the valuation? Advisers usually give you a range of what we think the business will sell for. If you don't like the bottom end of the range, don't even get started. You're often selling to competitors. If you begin the process and decide not to do a deal, they'll have learned a lot about your company.

What should entrepreneurs remember during the negotiations? Don't overpromise. It takes six months to finalize a sale, so you need two quarters of projections. You don't want to be in the middle of negotiations and have to explain why first-quarter projections were missed.

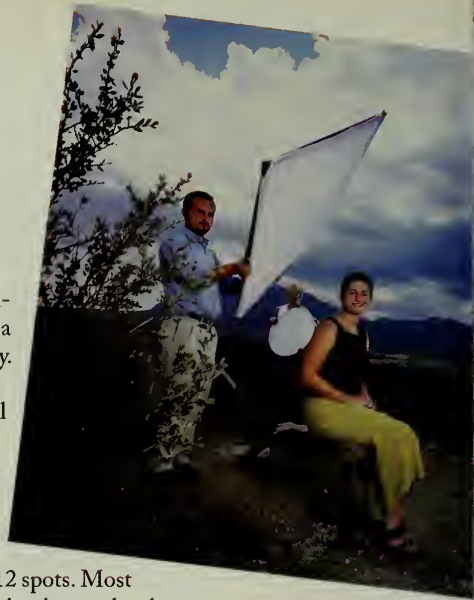
Capital Idea

YOU, TOO, CAN BECOME A VC

CARY KINROSS-WRIGHT wanted to be a venture capitalist. But while she had an MBA and experience as a chemical engineer, the venture world was a mystery.

Her answer: the 18-month VC training program at the Kauffman Center for Entrepreneurial Leadership. The program, which combines classroom **TEACHING AND ON-SITE TRAINING** at venture firms, has churned out 62 graduates, who have invested in 256 companies.

This year, despite the tech downturn, applications are at a record high—about 300 for 12 spots. Most applicants are between 25 and 38 and are either scientists, technology experts, or financial pros. Why so competitive? Look at Kinross-Wright. In the 12 months she has spent at Intersouth Partners in Durham, N. C., Kinross-Wright, 29, has shadowed one of the firm's founders, evaluating investments and sitting in on companies' board meetings. As a kicker on the deal, **FELLOWS GET AN ANNUAL STIPEND** of \$110,000 while enrolled. Something ventured, something gained.



VENTURE FORTH: Kinross-Wright getting on-the-job venture-capitalist training through the Kauffman Center

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Rosy Scenario

A BRAVE FEW ENTREPRENEURS (12%) STILL THINK THIS IS A GOOD TIME TO EXPAND. THEIR REASONS:

25%	42%	33%	8%
say they're encouraged by economic conditions	cite their prospects for strong sales	think they can get favorable loan terms	say they like the political climate

Data: National Federation of Independent Business, July, 2001. Figures exceed 100% because of multiple answers

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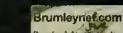
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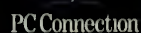
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FRONT

LINE

ANALYSIS

IDEAS FOR ENTREPRENEURS

STATS OF THE MONTH

55%

of fast-growth CEOs say cost-cutting tops their agenda

9%

of small-business owners say they "don't need" or "don't trust" technology

15%

of small-business owners work fewer than 30 hours a week



Leslie Segal "felt betrayed" when workers groused

MANAGING

Attitude Adjustment

BUSINESS MAY BE DOWN, BUT SPIRITS NEEDN'T BE **BY NAWEEN A. MANGI**

LESLIE SEGAL SENSED the change almost immediately. The eight employees of TestWare Associates Inc., her software-testing company in Piscataway, N.J., suddenly seemed grumpy and unmotivated. Lunch breaks grew longer,

and the phones often went unanswered. Rather than the buzz of hard work, TestWare's offices were soon filled with the drone of complaining.

What triggered such a shift? In December, the \$2.5 million company abruptly lost three

longtime clients, driving revenues down 30%. Employees, who had known nothing but steady growth, began to fear that the company's future, and their own jobs, were in jeopardy. They grew so distracted that performance began to suffer. "I felt betrayed," says Segal, 45, who now spends more time soothing her employees' fears than working on TestWare's actual projects. "My next company," she jokes, "is not going to have employees."

Unfortunately, going solo isn't an option for many entrepreneurs.

And for those like Segal who have not experienced a downturn before, managing employees has never been more of a challenge. "Entrepreneurs are panicked because they don't know or don't remember how to get through a recession," says Roxanne Emmerich, a Minneapolis business consultant. "Employees sense this fear and are very nervous."

SETTING THE TONE

THE QUESTION IS how to soothe those nerves. Segal's prescription: more information. She started a weekly e-mail newsletter that describes the various new projects the company is bidding on. "I can see they're working hard to maintain the business," says software-testing specialist Abe Hadded. "So I've become less interested in looking for a job outside the



Greg Matusky tries little touches of kindness

company." Segal has also used the downtime to send employees to training courses and networking events—an investment she expects to pay off when business picks up.

Perhaps most important, by taking action, Segal signalled to her employees that she was in control of the situation. "The leader sets the tone and becomes the mirror," says Richard Chaifetz, chairman and CEO of ComPsych Corp., a Chicago human-resources consulting firm. "Entrepreneurs who wear their hearts on their sleeves must be aware that this impacts employee attitudes."

It's not always easy to remain upbeat, though. In January, Gregory Matusky, the 40-year-old founder of Gregory Communications Inc., a public-relations firm in Ardmore, Pa., suddenly lost five clients—20% of his

business. "I was scared and devastated," he says. Soon, his 26 employees began to feel the same way, dealing with clients without enthusiasm and dragging their feet over small assignments. Matusky knew things had to change. "When you're facing low revenues and an employee walks into your office, the immediate instinct is to tell them to go away," he says. "But this is when you have to support them. Otherwise, it has a real snowballing effect."

HONEST TALK

TO RAISE STAFF SPIRITS, Matusky first appointed his most senior manager to act as mentor to junior associates, most of whom had never before seen bad times and had little idea of how to handle clients in the new economic environment. "It's natural to get bummed out when you lose an account," says Sharon Sargent, a 26-year-old account executive who has worked at the agency for three years. "It helps to talk to somebody who says: 'I know, I've been there.'" Matusky also started an e-mail newsletter, titled *Did You Notice*, in which he highlights employees' achievements. On a more playful side, Matusky installed a table-hockey game in the conference room and treats employees to lunch on a regular basis.

But workplace experts caution that cute perks only go so far. "You can do these things all day," says Chaifetz, "but if you don't talk honestly and create a vision, you will not have a company. Unless of course you have the company. Segal dreams of: one without workers."

—With Cynthia Daniels in New York

@SB For more advice on how to revive flagging employee morale, click Online Extras at smallbiz.businessweek.com



Q I'm a consultant known for fast work, but I worry that I'm being cheated by my own efficiency. Should I work slower or charge more? —R. H., Encino, Calif.

A Do not work slower—your speed and quality are tremendous values and should be

used as selling points. Figure out what your competitors charge for similar work, and adjust your rates accordingly. For small jobs, charging hourly may be best. You can also bill on a per project basis, but if you underestimate the time required for a job, you'll lose money. And if your margins are healthy,

"don't be afraid to stay the course," says small-business coach John Delmatoff in Diamond Bar, Calif. For more pricing tips, check out Alan Weiss's book *Million Dollar Consulting* (1997, McGraw-Hill, \$14.95). But for personalized advice, consult your pocketbook.

—KAREN E. KLEIN

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to manage your
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sooner or later, you
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WHO'S HOT

Does Soap Sell If You Talk Dirty?

SO FAR, THE TACTIC SEEMS TO WORK FOR BLUE Q

DIRTY GIRL, VIRGIN/SLUT, and Total Bitch don't sound like promising consumer-product brand names. But Seth and Mitch Nash, founders of the bath-and-gift-product company Blue Q, are hardly your typical marketers.

The Nash brothers specialize in using provocative, retro packaging and cheeky humor to sell mundane gift items like refrigerator magnets, makeup bags, bubble bath, and soap. Evidently, there are plenty of people who like to feel dirty while getting clean. The 45-person company, based in Pittsfield, Mass., now has products in more than 3,500 boutiques and specialty stores nationwide. They expect sales of \$8 million for 2001, up 27% from last year—all with no advertising.

Among Blue Q's offerings: Wash Away Your Sins towellettes,

which claim to right your wrongs on contact and leave you morally purified; Love Potion No. 9 lip balm ("start a fire with your lips"); and for him, Mr. Pit

Stop body wash, for a "full-service cleansing." The 60-product Dirty Girl line is the most popular, making up more than a third of sales. "We want you to smile as you walk to the register," says Mitch, a 41-year-old entrepreneur who handles much of the creative side. Big brother Seth, 43, a former engineer, is the business chief.

"FUNKY AND FRESH"

THE BROTHERS, practical jokers who had always dreamed of starting a business together, got their start in 1988, when they quit their day jobs to introduce the Pet Rock-like Flat Cat, a cardboard kitty cast as the perfect pet. Its success inspired more "flat" items, including babies and dogs. Those were followed by a hit series of magnets packaged around themes like White Trash—which include a trailer, a tabloid, and a six-pack. From there, they decided to target bath and beauty products. Says Seth: "We knew we could put our spin on soap."

But don't call them gag gifts. The Nashes are quick to point out that they use top manufacturers to make their products. (A bar of Dirty Girl soap costs about \$8.) "Their stuff is funky and fresh, but not too expensive," says Cate Marx, a manager at the House of Mirth boutique in Richmond, Va. But Blue Q is aiming to get out of the boutiques and into the mass market. At least two major retailers are sniffing out deals to distribute their products nationwide. The question for the Nash boys is how to move to the big leagues without alienating the quirky retailers

that helped them build a name. Then there's the challenge of proving Blue Q products are not just fads. "We're not like the Pet Rock, where you need to get in and get out," says Seth. "We really want to build these brands."

Is the corporate world ready to accept store shelves full of Virgin/Sluts? At least one major player isn't. Virgin Group Ltd., the British conglomerate run by the Nashes' hero Richard Branson, is suing Blue Q over its Virgin/Slut line. It says the brothers are infringing on Virgin's trademark, which includes a cosmetics business that did about \$70 million in sales last year. Seth claims to be surprised, insisting that he and Mitch have no plans to start Virgin/Slut Airlines or a record-store chain. "Is my grandmother going to have her extra virgin olive oil taken away, too?" he asks. On the other hand, the Nash boys know all too well the power of a catchy brand name.

—DIANE BRADY

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BLUE Q

WHO: Seth and Mitch Nash, co-founders

Ages: Mitch, 41; Seth, 43

Products: Soap, bubble bath, makeup, and other gift items

Edge: Savvy packaging skills give everyday objects a super-trendy sheen



MASS APPEAL? Blue Q is aiming to break out of boutiques



JOKERS WILD: Seth (left) and Mitch Nash

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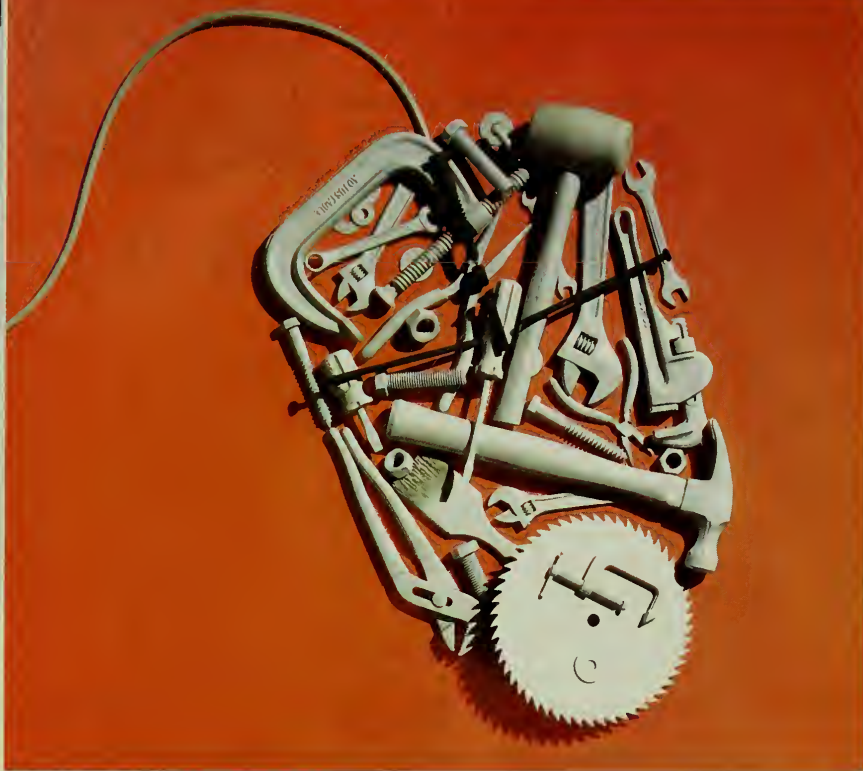
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DIGITAL MANAGER

And Your Host Is...

MICROSOFT AND ORACLE SERVE UP NEW ONLINE TOOLS

GEISEL INC., A PLUMBING supply house in Elyria, Ohio, is like a lot of small businesses moving onto the Web. Geisel markets and sells products online. But the 65-year-old store can't run its entire \$4 million-a-year operation over the Internet. Its most critical software application—a database program customized for the plumbing and air-conditioning industry—still runs on a local-area network.

Microsoft and Oracle Corp. would like to change that. The perennial combatants dream of the day when all small businesses will tap software hosted on the software giants' computer servers—rather than on the businesses' local-area network or desktop PC—to run the guts of their companies. The hosted software would be extremely flexible, and customized by users in nearly any industry.

For now, it's a pipe dream, for plumbers or anyone else. Still, Microsoft and Oracle have made remarkable progress. Both now offer integrated Web-based applications that—while hardly indispensable—can make running a business easier.

When they were launched two years ago, Microsoft bCentral and what is now Oracle Small Business Suite were very limited. BCentral was a collection of disparate programs that could be opened at the same Web address. Oracle Small Business Suite (then known as NetLedger Inc., which has now partnered with Oracle) provided just an online accounting program. That intrigued a lot of business owners, says Stephen Wolfe, the Oracle vice-president in charge of the small-business suite, but didn't win many customers.

RANDOM access



DIGITAL I.D.

PCs in the office are usually protected from unauthorized access, but on the road a laptop is more vulnerable. The Ethenticator MS3000 from Ethentica Inc. keeps out intruders with a tiny fingerprint scanner on a PC card. To log on, authorized users simply place a designated finger on the card's scanner, which sticks out of the slot (www.ethentica.com, \$179).



HOAX HANDLER

While virus attacks are a real threat, many "virus alerts" are pranks—particularly those passed around by e-mail. To identify hoaxes, the Symantec Corp.'s Security Updates site offers a free comprehensive list of fakes, plus a link to an "encyclopedia" of real viruses (www.symantec.com/avcenter/hoax.html).



PEACHTREE PICKINS

You can now work with your Peachtree accounting data from any Web connection. Peachtree Web Accounting isn't a conventional application service provider: In the office you still use standard Peachtree software. But the data are synchronized on—and available from—Peachtree's computers. (www.peachtree.com; \$9.99/month, single user, \$19.99/month, multiuser access).

Now, following separate overhauls this spring, bCentral and Oracle Small Business Suite offer more than a half-dozen integrated applications, including customer-service and Web-site-development programs. Since last year, 65,000 small businesses purchased bCentral subscriptions. Oracle says 5,000 small businesses had paid for service as of August.

Should you join them? Consider two things: your computing needs and the price of meeting them. Nei-

ther service offers every application you're likely to want (table). For example, if you use human-resource software to track employee benefits, or supply-chain software to track product distribution, you'll need to stick with what you have; neither service offers them.

VIRTUAL MEETING ROOMS

WHAT ABOUT PRICE? If you're building a simple Web site, then bCentral—sold à la carte, starting at \$29.95—is your best bet. It's cheap and easy. But if you're looking to do more, Oracle might be better. It offers a monthly flat fee of \$99, with à la carte rates starting at \$9.95 per user per month. Do the math, and you'll find that a small business with five bCentral users pays \$2,103.65 a year for e-commerce, accounting, customer-relations management, and Web-site administration software. For roughly the same features, but including payroll software, Small Business Suite would cost the same business \$1,188. Geisel, by the

way, expects to pay \$2,400 to \$3,600 in the next 12 months for its bCentral services, and to generate \$60,000 in incremental sales electronically.

While Microsoft hasn't announced any changes in bCentral's pricing, it is trying to improve the service. The first step is the introduction of Microsoft Great Plains Small Business Manager, planned for later this year. The new program, the result of Microsoft's \$1.1 billion purchase last December of Great Plains Software Inc., will offer features unavailable in bCentral's Finance Manager, such as payroll services, advanced financial analysis, and account balancing—which Small Business Suite already has.

Other improvements scheduled for the next 18 months include further integration of Microsoft's popular Office suite. bCentral users will be able to send and receive data between desktop versions of the software and bCentral, turning the Web service into a companywide network. Already,

bCentral can be used with three programs: Microsoft Outlook, an e-mail and contact management module; Excel, a spreadsheet program; and FrontPage, a Web-site management tool. A fourth, intranet software called SharePoint, was made available on bCentral in late May. Using SharePoint, small businesses can create virtual meeting rooms and upload data directly from Office XP, the most recent version of Office.

WORK IN PROGRESS

FOR NOW, bCENTRAL still has some kinks. For example, you can upload—but not download—an Excel spreadsheet to bCentral. And you can import lists—but not transactions—from Intuit Inc.'s QuickBooks, the most widely used small-business accounting program. Also needing help is the online help desk. Submit a question as prompted, and there's a good chance you'll receive an automated request to resubmit it. And SubmitIt!, a service that allows small businesses to submit the name of their bCentral Web site to search engines, "is a little unpredictable," concedes Satya Nadella, vice-president of bCentral at Microsoft.

Oracle has work to do, too. Its software to keep customer profiles updated is little more than a contact manager and calendar. Oracle says it will be replaced in October by an expanded program that will include an automated sales program that tracks whether a prospect has become a customer, and easier-to-use payroll software. Next year, Oracle plans to add human resources software and a supply-chain-management module—and you'll probably pay extra for them.

When all these improvements are complete, will you be persuaded to turn an old-line business into an online one? Maybe not. But rest assured, with Microsoft and Oracle hosting, the party has just begun.

—KEVIN FERGUSON

Remote Control

What portions of your business can you run online?
The menu of hosted services is growing fast.

MICROSOFT'S BCENTRAL OFFERS:

Commerce Manager, a tool for building online catalogs and conducting e-commerce

Customer Manager, which allows you to track sales and make appointments

Finance Manager, an accounting module

Web Services, a collection of tools to create and manage a Web site Traffic Builder, including Submit It! and List Builder, to register your site's domain name with search engines, advertise online, and create e-mail

ORACLE SMALL BUSINESS SUITE OFFERS:

Time and Billing, which lets you track time spent with clients

Employee Center, an expense-report program

CRM, a contact manager and calendar (due to be updated in October)

Customer Access, which lets customers view their accounts

Web Site, tools to set up and manage your site

Purchasing, which lets you track purchases from suppliers and generate checks and purchase orders

Payroll, for processing payroll, which includes printing checks and W-2 forms

Reporting, a collection of report templates

Security, which allows you to set up different access for different employees

@SB For advice setting up a Web site with an online service, click Online Extras at smallbiz.businessweek.com

CREDIT-CARD MANIA

Where to find the best rates, most perks, and lowest fees

BY NAWEEN A. MANGI

AS FAR AS JOEY TOMKO IS CONCERNED, he's the king of credit-card freebies. Consider his treasures: a \$1,800 sit-down lawnmower for his yard, two \$800 go-carts, a \$1,000 big-screen TV, and a \$500, six-foot-high tropical fish tank for his office—all free. The source of his spoils? The Wells Fargo Platinum Business MasterCard, which he uses for his company's charge account. All told, the card has given Tomko \$15,000 of such stuff as bonuses.

That's not all. Tomko, president of Government Sales Associates Inc., a \$4.3 million, five-person computer hardware supplier in Sacramento, Calif., has also racked up 150,000 frequent-flier miles, which he used to send his office manager on vacation to Mexico, fly his father in for a visit from Florida, and make seven trips of his own. And the rewards keep coming, pumped up by cards Tomko gave his three sales execs for business entertainment. "I milk the card for all it's worth," he crows. Tomko, who pays off his \$5,000-a-month average balance to avoid interest charges, says he may get another card, too.

PERKED UP

Joey Tomko shows off some of the spoils he accrued by using his business credit card



A man with blonde hair and a beard, wearing a blue t-shirt and khaki pants, is sitting on a red tractor. He is holding a white milk carton in his right hand and a metal milk canning tool in his left. A bottle of beer is on the tractor next to him. The background shows a sunset or dusk sky with some trees and a building in the distance.

“
I MILK THE
CARD FOR ALL
IT'S WORTH
”

“

I WOULD SPEND THREE OR FOUR HOURS A COUPLE TIMES A WEEK MONITORING ALL THE CHARGES”

Certainly, it's easy to abuse credit cards and run up debt your company can't afford. But used wisely, the cards can be a real benefit. They can help finance expansion, keep better track of spending, and, yes, let you accumulate more stuff.

The timing is pretty good, too. As small-biz card issuers clamor for your business, there are better perks, a greater array of choices, and more favorable terms than you could get on a personal card. Frederick (Md.)-based CardWeb.com Inc., an independent monitor of credit-card offerings, now counts about 100 issuers offering 300 different small-business credit cards—triple the number available just two years ago. Besides freebies such as unrestricted airline miles and points redeemable for DVD players and digital cameras, you can choose a card with no annual fee, free cards for employees, and single-digit interest rates, which were a rarity just four years ago. To help manage your expenses, some offer companywide online reports.

EXPLODING MARKET

TODAY, 48% OF SMALL-BUSINESS OWNERS use a small-business card—up from 29% two years ago. As of December, 2000, about 20 million small-business cards had been issued, says CardWeb.com—more than double the 9 million three years ago. Meanwhile, credit-card mail solicitations, both business and personal, are at an all-time high, and the deals keep improving. Over the summer, MasterCard International introduced its redeemable points program, which lets you accumulate points to spend at 21 million locations worldwide where MasterCard is accepted. Visa followed with a handful of new discounts for auto rentals and hotels. American Express Co., trying to appeal to entrepreneurs with a social conscience, launched the Community Business Card, which donates 1% of all credit-card receipts to finance tiny startups run by women and minority entrepreneurs.

Different features, of course, appeal to different entrepreneurs. If you're looking for a big credit line, MBNA's Platinum Plus for Business card offers the largest—as much as \$250,000 without any annual fee and an unlimited number of free cards for your employees. Want low rates? Check out Capital One's Platinum Visa for Business. Depending on your credit rating, you could be among the lucky ones offered a 0% introductory interest rate for about six months, followed by a fixed rate of 9.9%. As for free air-

line miles, you could stuff an entire wallet with such cards, but only a handful of business issuers, such as Advanta's Bonus Miles Business MasterCard, let you redeem them with no restrictions.

Indeed, it pays to read the fine print. You might be attracted to the Midwest Express Gold Business MasterCard, for example, because of its generous airline rewards program—2,500 bonus miles when you first sign up and a free domestic round-trip after you've racked up 20,000 miles. But the card also carries a 16.9% variable interest rate and a \$55 annual fee. American Pacific Bank Secured Standard Business Visa lets you get a credit line of up to \$15,000—even if your credit history is shaky—but it also carries a hefty 17.4% fixed annual interest rate, and a \$45 fee per card.

LAST RESORT LENDERS

GIVEN HOW LOW RATES ARE, perhaps the ultimate perk is the ability to write yourself a loan. With APRs as low as 9.9%, and teaser rates even lower than that, credit-card financing looks more attractive than ever. Last year, 50% of small businesses used business or personal credit cards as a financing tool, vs. 24% in 1996, says a survey by Arthur Andersen LLP. “This form of unsecured credit has been a real shot in the arm for small businesses,” says David Robertson, president of *The Nilson Report*, an industry trade newsletter.

Some savvy entrepreneurs have landed the most attractive deals by rate-surfing—choosing a card with a low introductory rate and, before it expires, transferring the balance to another card with a low introductory rate, and so on. Five years ago, Tom and Marilyn Rodammer, co-founders of The Listening Room, a \$1.5 million retailer of home entertainment systems in Saginaw, Mich., needed \$120,000 to renovate their showroom. The seven-person company couldn't get a bank loan, so the Rodammers decided to rate-surf. Over five years, the couple ran through 20 different credit cards, including two business cards. They found the technique so successful, they wound up borrowing another \$120,000 to do even more renovations, at an average interest rate of about 10%. It is not, however, a technique for the less-than-meticulous manager. “It was difficult, tedious, and time-consuming,” says Tom Rodammer. “I would spend three or four hours



a couple times a week monitoring all the charges.”

But the strategy worked. The business got what it needed for expansion, and the company tripled its revenues as a result of the renovation. The Rodammers finally paid off all their card debt in June after obtaining a commercial mortgage and a line of credit from Cleveland-based National City Bank.

Still, it's easy to get overextended, as John Glistos learned. Ten years ago, when he started his interactive kiosk manufacturing company, Scottsdale (Ariz.)-based First-Wave Inc., Glistos figured his \$250,000 in savings would be enough both to fund the company and pay personal expenses. It wasn't. After two local banks turned him down for a loan, he started rate-surfing among more than a dozen cards, and from 1992 to 1994, Glistos piled on \$57,000 in debt. “There were points at which I couldn't make sufficient payments, and I would get harassing calls from creditors in the middle of the night,” Glistos recalls. “It got pretty ugly.” He carried the debt for six years, finally paying off the last of it early this year. His 13-employee company has continued to grow and now has revenues of \$1 million.

While Glistos pulled himself out of the hole, banks

RATE-SURFERS

Tom and Marilyn Rodammer financed a renovation of their showroom with cards

write off about 7% of business credit-card debt as uncollectible, according to CardWeb.com. But that doesn't mean they don't try: In fact,

virtually all small-biz card issuers demand that you personally guarantee payment and pledge your own assets, and sometimes they ask officers and partners to co-sign, too.

Nevertheless, a bad credit record won't faze some issuers. In May, Wells Fargo & Co. launched its pioneering Business Secured MasterCard, with credit lines up to \$100,000 for new small companies or those with impaired histories. Although the fee and interest rate on the card are competitive, entrepreneurs are required to secure the credit line fully with an equivalent amount of cash in a bank account. Why should you bother? Unlike most other business credit cards, which are tied to your personal credit history, this one allows entrepreneurs to build up a credit history in the company's name. At the same time, they can take advantage of MasterCard's discount offers and rewards programs.

Assuming you don't spend yourself into bankruptcy,

PLASTIC FOR EVERYONE

Do you care most about low rates, low fees, or big rewards? Here's a sampling of cards that are smart choices—depending on your priorities.

LOW RATES

NAME	APR	ANNUAL FEE	EXTRA CARD FEE	PERKS
Capital One Platinum Visa Business 800 933-5182 www.capitalone.com	9.90%-19.80% (fixed)	\$0-\$29	None	Online access
Advanta Bonus Miles Business MasterCard 800 780-3945 www.advantabusiness.com	9.99%-24.99% (fixed)	\$40.00	None	Earn unlimited points; travel on any airline without blackout dates
Bank of America Business Visa 800 352-4041 www.bankofamerica.com/smallbusiness	10.65%-16.65% (Prime + 3.90% to Prime + 9.90%)	\$25-\$45	\$25-\$45	\$500,000 travel accident insurance; business-based credit

LOW FEES

American Express Blue for Business 800 628-2244 www.americanexpress.com/blueforbusiness	10.65% (Prime + 3.99%)	None	None	Online account access; top customer service; smart chip technology
Chase Manhattan Business MasterCard 800 320-6782 www.chase.com	11.75% (Prime + 5.00%)	\$50	None	Chase rewards program
MBNA America Platinum Plus for Business MasterCard 800 598-8791 www.mbna.com	13.99% (Fixed)	None	None	Online access; top customer service; high credit limits; \$1 million travel accident insurance

BEST PERKS

US Bank WorldPerks Business Visa 800 344-5696 www.usbank.com	16.50% (Prime + 9.75%)	\$75	\$75	Earn miles on Northwest Airlines with no blackout dates or restrictions
Citibank AAdvantage Business MasterCard 800 732-6000 www.citibank.com	16.90% (Prime + 9.90%)	\$75	\$25	Earn miles on American Airlines with no blackout dates or restrictions
Wells Fargo Business Secured MasterCard 800 359-3557 www.wellsfargo.com	12.90% (Prime + 5.90%)	\$25	\$25	Secured credit lines up to \$100,000 and 4% annual rate on security deposit for one year; also offers a Business Miles rewards program

Data: CardWeb.com Inc.

the credit cards also offer a way to track companywide expenses more efficiently, offering periodic reports that break down spending by category. "In the last one or two years, our customers have become very interested in credit-card products that will help them manage their business," says Michael Carbone, director of small-business card products at J. P. Morgan Chase & Co. Many issuers now offer online reporting, where you can view your charges at a

password-protected Web site, or through an e-mail update service. Some let you download spending reports into your accounting software, and Fleet's Smart Visa will send e-mail alerts when an employee exceeds his or her credit limit.

HOW TO CHOOSE

TO FIND THE BEST CARD for your business, consider your priorities (table). If you intend to pay off your balance each month, then you can focus more on the goodies and less on interest rates. If it's the convenience of electronic payment you're looking for, then double-check to ensure that vendors you use accept that card. And to use the card as an effective expense management and organizational tool, check that the issuer has the ability to offer frequent reporting, online access, and the option to download reports into your money management software.

Rewards programs vary, also. "Don't be too dazzled by the frequent-flyer points," says *The Nilson Report's* Robertson. If the only travel you're doing is to your local office supply store, you're better off looking for cards that offer discounts on your purchases. All MasterCard small-business cards, for example, give users a 20%-to-36% discount on office supplies at pennywise.com. Check if the issuer loads on more fees if your staff grows, and whether cards issued to your employees can be assigned individual credit limits. One other caveat: Perks are tax-free if you use them for your business. They might be taxable if put to personal use, but so far, the IRS hasn't decided to enforce the idea.

To be sure, the rewards programs may become less generous when most entrepreneurs have settled on a business card they like. Maybe card issuers will tire of hawking lawn mowers, free flights, and fish tanks, and Tomko, the king of credit card freebies, will have to turn in his crown. Until then, enjoy the royal treatment.

@SB The newest small business plastic to offer rewards is a debit card. Click Online Extras at smallbiz.businessweek.com

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HOW TO GET even WITH GOLIATH

Most people cave when a big corporation pushes them around. Louis Saia pushed back—and took away \$25 million. By **STEPHANIE B. GOLDBERG**

THE DAY COULDN'T HAVE GONE

better if he had scripted it himself, mused Louis P. Saia III. It was May 17, 1995, and the CEO of 12-employee Pallet Reefer Co. in Houma, La., had completed a long but productive meeting in Menlo Park, Calif., with his joint-venture partners and their biggest client. Afterward, they had all chatted amiably over dinner at an Italian restaurant.

Saia was confident that his patented invention called the "pallet reefer" would make him and his wife, Cindy, multimillionaires. The "reefer" is a stackable shipping container, cooled with a compressor like a refrigerator. Saia believed it would revolutionize the trucking industry because it can be used to ship small loads of perishables alongside other cargo. In the daylong meeting with the client, Con-Way Transportation Services, it seemed they had cleared up to Con-Way's satisfaction how certain design flaws could be corrected. Now, surely, thought Saia, his joint-venture partners—the big truck manufacturer Grumman Allied Industries—would finally jump-start the

project, which had stalled in 1994 when the parent company, Grumman Corp., merged with Northrop Industries. Little did he know he was standing on the edge of an abyss.

There in the Con-Way parking lot at twilight, Saia stopped his Grumman Allied partners as they were leaving. James McConnell, CEO of Grumman Allied and its representative in Allied Transportation Products—the entity created by Grumman for the joint venture in 1992—rolled down his window. "I said, 'Hey, fellas, what do you think? Have you reached a decision?'" recalls Saia. Yes, said McConnell. They wanted to proceed with the Pallet Reefer—just not with Saia. Stunned, Saia begged them to reconsider. "That was the moment I realized they were trying to muscle me out of my company," says Saia, now 45. He had reason to think so: McConnell would admit later in legal proceedings he didn't like Saia, was irritated by the man's emotional personality, and had decided earlier Saia had to go.

That September, Saia made a wrenching decision—to sue his corporate partner for breach of contract. The ensuing legal battle would drive him and his wife to near-bank-

LEGAL AFFAIRS

Small Biz BusinessWeek



FAITH AND PERSISTENCE
Faith and persistence helped the Saias tough it out through three years of litigation

ruptcy, imperil their marriage, and engulf him in anxiety. Yet, the couple later realized, it would have been far worse to give up without a fight. "If Grumman won," says Cindy Saia, 39, a chemical engineer and vice-president of the company, "it would mean our hard work was for nothing and there was no justice. In my heart, I knew that wasn't so." Saia's own father, a wealthy Louisiana trucker, scoffed at the notion that his son could beat Goliath. "He told me I had a better chance of winning the lottery," says Saia.

HOW OFTEN DOES A BIG COMPANY

breach a contract—as in Saia's case—or not pay a vendor, or push a small rival out of the market, or try to acquire an inventor's technology on the cheap? Surely often enough to generate horror stories in every industry. But usually entrepreneurs surrender quietly and move on. The reason is simple: "The chance of a small business being able to outlast a large business in litigation is practically nil," says Bob Meade, senior vice-president of the American Arbitration Assn. To pursue a lawsuit, "you almost have to be a little loony," says Richard M. Leisner, a Tampa lawyer and former chair of the American Business Assn.'s small-business subcommittee. "You have to be a driven-CEO type who's going to make the lawsuit your baby."

The cost alone is daunting. Litigators capable of taking on a big corporation charge around \$400 an hour, and a patent case that goes to trial can cost more than \$500,000, says *Inventors' Digest*. So most entrepreneurs need a lawyer willing to work for a contingency fee. But that means you'll lose 25% to 40% of any recovery, plus expenses. Even then, lawyers frequently demand clients share the ongoing costs of a suit. That's assuming you can find one. "I reject about 90% of the cases offered to me," says Raymond P. Niro Sr., a Chicago lawyer renowned in intellectual property circles as a giant-slayer. And many top litigators will take a case on contingency only if they expect to earn millions.

What's more, the emotional stress and time consumed by litigation can be overwhelming. "We had no idea what it was going to take," says San Francisco architect Glenn A. Storek, whose battle against a Citigroup real estate subsidiary has dragged on for eight years. Last year, he and his brother Richard, also an architect, won \$41.8 million after convincing a jury that they had been pushed into bankruptcy by Citicorp Real Estate Inc., which served as bond agent on an Oakland (Calif.) project. But the case isn't over. Citicorp attorney R. Paul Wickes says he's confident his client will prevail on appeal. "An enormous amount of time has gone into keeping the lawsuit going," laments Richard Storek. "In the process, we lost our homes and our personal possessions."

Builders, telecom resellers, convenience stores—no small business is immune to a face-off with a giant. The companies most at risk are ones that share information with prospective backers or clients, lawyers say. "The big company makes promises to compensate them. Then when they get

their hands on the idea, they cut the little guys loose," says Niro, one of the few lawyers who specializes in David vs. Goliath suits.

Occasionally, though, Goliaths underestimate the mettle—and the fury—of a scorned entrepreneur. Take Joseph Freda, president of C&F Packing Co. in Elk Grove Village, Ill., a 120-employee meatpacker with \$40 million in revenues, a Niro client. "I was determined I wasn't going to let anybody destroy what my father had worked his tail off for," says Freda. So in 1993 he sued Pizza Hut Inc., once a major customer, alleging it had stolen his family's sausage recipe and technology and passed it along to the \$16.9 billion meat processing giant IBP Inc. He sued IBP, too, and after a seven-year battle, an appeals court last year upheld a \$10.9 million judgment against the packer. And Pizza Hut? In a series of twists and turns typical of high-stakes litigation, Pizza Hut was dismissed from the original suit, then reinstated on appeal. Robert W. Millen, general counsel of Pizza Hut in Dallas, denies all of C&F's charges. The trial is now scheduled for January, 2002—more than eight years after the suit was first filed. "The name of the game is delay, delay, delay," says an exasperated Freda.

THERE WERE NIGHTS WHEN

Louis Saia paced his kitchen floor, popping Valiums that no longer had any effect on him, and wondering if he had made a terrible mistake. Certainly nothing had gone smoothly in the months after the parking lot encounter. He says he had rejected Grumman Allied's offer for a \$2 million buyout as an "insult." His personality conflict with McConnell had grown sharper. And in August, Grumman Allied, which had provided much of the capital and manufacturing expertise for the joint venture, largely shut down Pallet Reefer's operations, prompting Saia to file his suit. Later in the legal proceeding, Grumman alleged—and Saia denied—that Saia lost \$12 million for the joint venture through mismanagement and by funneling business to a small trucking company he owned.

Then things got worse. In January, 1996, Allied Transportation petitioned a Delaware court to liquidate the company, citing a boardroom deadlock between the Saia and the Grumman Allied representatives. Had Grumman succeeded, speculates Saia, it "would have forced a sale of my patent, which they could have inexpensively acquired." Next, Allied Transportation laid off all of Pallet Reefer's employees, including Saia, leading Con-Way to cancel its contract the next day, according to an arbitrator's findings. McConnell, who now heads up a management spin-off of Grumman Allied, declined comment, noting that his company is no longer part of Northrop Grumman. Northrop Grumman officials also declined comment.

As spring approached, Saia's despair deepened. His lawyers had bailed out in January when he could no longer



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pay them. He had run through \$2 million in assets, and at one point the family checking account held just \$60. "I was waking up at night hopeless, broke," says Saia. "My marriage was on the rocks."

There's no question when Saia hit bottom. The day is etched in his memory. On Mar. 16, 1996, he says he had "violent thoughts" about "stalking" Northrop Grumman's executives. "I gave thought to a trip to Los Angeles to pursue my vendetta," he says. But on Mar. 17, as he was out jogging to relieve his despair, Saia says he experienced a vision of the Virgin Mary on the steps of his office. He says she told him "to just have faith in my son," and from that moment on, he felt a sense of peace.

Call it faith or coincidence, but the Saia's saw their fortunes improve. That month, New Orleans lawyer Jack M. Alltmont agreed to take the case on contingency. "I frankly thought, 'Well, we'll get into it and we'll settle,'" says Alltmont, who instead spent the next year on the case. Saia also hired a lawyer in Delaware—using borrowed funds—to block the liquidation of the company. Ultimately, the Delaware judge ruled that liquidation wouldn't resolve the breach of contract issue. At that point, both sides agreed to arbitration, which began in New York on June 2. "If we lost, we would have gone bankrupt," says Saia. "But we knew we weren't going to lose."

For a year, as they commuted to New York for monthly hearings, the Saia's lived on credit cards and prayer. Finally, on Dec. 2, 1997, the arbitrator awarded Saia \$18 million, finding Allied Transportation had breached its contract and rejecting Grumman Allied's allegations against Saia. He had just \$2 million left after the lawyers took \$4.5 million, and he paid off his creditors. Six months later, he sued Allied Transportation again, charging his ex-partner failed to return his patents on time as ordered by the arbitrator. The result: Allied Transportation settled for \$7 million.

Flush with cash, Saia moved quickly to revive his beloved Pallet Reefer. He poured \$3 million into the business, including the purchase of an abandoned factory from the local parish for \$700,000. His goal: to begin producing 15 pallet reefers a day starting this fall. This time, no outsiders will get any equity.

That's the business. The Saia's also gave \$700,000 of their winnings to charity. "I feel God has something planned for us, and we don't yet know the end of the story," says Cindy Saia. For now, though, the curtain has come down on their legal drama. And for that, they say: Amen.

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SAUSAGE BELLY
Niro (left) helped
Freda take on
mighty Pizza Hut



GIANT KILLERS

Some advice from top litigators who have recently won big cases for small companies

ATTORNEY: Raymond P. Niro Sr.

FIRM: Niro, Scavone, Haller & Niro in Chicago

BIG WIN: A \$57 million verdict in 1997 for an inventor who persuaded a jury that his fuel-injected engine design was taken by Polaris Industries Inc. An appeal cut the award by \$12 million but upheld 10 years of interest. The total take: more than \$75 million.

ADVICE: Before you let prospective partners see any proprietary material—patented processes, trade secrets, business plans—have them sign a nondisclosure agreement. Apply for patents, copyrights, and trademarks as soon as possible.

ATTORNEY: William C. Carmody

FIRM: Susman Godfrey in Dallas

BIG WIN: A \$61 million verdict last year for a Texas contractor who charged that Chevron Corp. didn't disclose the toxic contamination of a construction site. The case was ultimately settled for an undisclosed amount.

ADVICE: Realize that suing a major corporation is like taking on a second job. To paraphrase Sun Tzu in *The Art of War*, the only way little armies can beat big ones is by outthinking and outworking them.

ATTORNEY: E. Robert Wallach

FIRM: Sole practitioner in San Francisco

BIG WIN: A \$41.8 million verdict last year for two San Francisco architects who claimed a real estate subsidiary of Citigroup had mishandled financing for their rehab project in neighboring Oakland.

ADVICE: Don't be a bystander. Help your lawyer understand the facts as well as you do. Help gather documents, attend depositions, feed questions, and catch misrepresentations.

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THE NEW BARRY DILLER

Can he turn
a bunch of
shopping outlets,
e-commerce sites,
and cable channels
into a media empire?

It is 10 a.m. on a sun-drenched Sunday in Los Angeles, the kind of day when big-time Hollywood executives wake up at their Malibu beach houses and maybe brunch with friends at the Hotel Bel Air. Barry Diller is having none of that. Fresh from a hike in the nearby hills, the 59-year-old media executive is padding through the converted pool house at the rear of his sprawling five-acre home off Coldwater Canyon, barefoot and sweating in his blue T-shirt and matching shorts. It has already been a heavy week of meetings, with more on his agenda. An agreement with the Professional Golf Assn. is nearing completion. Now, Diller is gathering papers he'll need to meet with executives from Microsoft Corp., who are due at his house shortly. "The entertainment industry used to be so simple," he says. "You made a movie or a TV show, showed it in a movie theater, maybe sold some videocassettes," he says. "Now, if you're not whacked in the face by the complexity of this business, you're just not paying attention."

No one is likely to ever accuse Barry Diller of not paying

attention to the shifting currents of the media world. The guy who all but invented the "movie of the week" concept for network TV while a twentysomething programming whiz at ABC, Diller has had his finger to the wind for nearly four decades. In the late 1980s, at the height of the power of the Big Three TV networks, he launched the Fox network, helping to splinter TV audiences with the help of a spiky-haired character named Bart Simpson. That was only a few years after Diller had resurrected the fortunes of Paramount, transforming the woebegone studio with a flurry of hits like *Raiders of the Lost Ark* and the TV show *Cheers* to cement his reputation as media miracle worker.

These days, however, Diller is preaching a transformation of a different sort. For most of the last decade since leaving Fox, Diller has assumed a self-appointed role as the media

Entertainment

world's leading apostle of the coming era of convergence. Down the road a few years, he says, TV viewers will browse, shop, and select from their living rooms, ordering everything from a pizza to a trip to Fiji. And while that day may still be somewhere down a murky road, Diller isn't waiting.

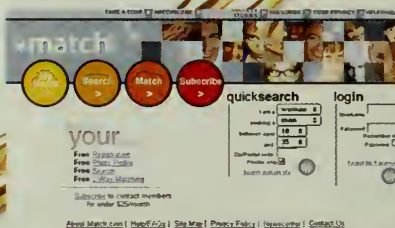
Indeed, today Barry Diller is more merchant than media mogul. Working mostly out of sight, he has been cutting deals faster than a peddler on payday. Since 1999, he has struck more than 30 separate deals, collecting Internet sites, call centers, and warehouses—creating the backbone for a media world that Diller insists will be driven by the interactive sale of goods and services.

Eventually, media companies will generate more than half of their revenues from transactions, says Diller. That's just what his own company, USA Networks, did last year, with

WELCOME TO BARRY'S BAZAAR

USA Networks Inc., which is 43% owned by French media giant Vivendi Universal and 21% by cable baron John Malone's Liberty Media, is an assemblage of properties that Diller has pieced together since 1999.

▼ **HOME SHOPPING NETWORK** The 24-hour shopping channel is seen in more than 155 million cable and satellite homes worldwide, generating sales of \$1.8 billion last year. The two-year-old HSN.com generated \$40 million in revenues in 2000.



▼ **TICKETMASTER** The world's leading ticketing service sells 83 million tickets a year through 3,800 retail ticket centers, 20 call centers, and ticketmaster.com. It also operates Citysearch, which provides 100 online city guides, and match.com, an online matchmaking service (68% owned by USA).

► **PRECISION RESPONSE CORP.** Provider of customer services with 11,000 operators to handle telephone and Internet orders for clients such as American Express and AT&T.



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▲ **USA ELECTRONIC COMMERCE SOLUTIONS** Sets up and operates Web sites for other companies to sell merchandise. Customers include NASCAR, the NBA, and PGA.



▼ **HOTEL RESERVATIONS NETWORK** Provider of discount hotel accommodations, 2,600 hotels in global markets. It has four Web sites including www.hoteldiscount.com and has affiliation with Travelocity and Cheap Tickets (70% owned by USA).

more than two-thirds of its \$4.7 billion coming from sales of everything from Suzanne Somers' newest diet book to tickets to a Los Angeles Laker game (chart, page 80). USA's Home Shopping Network (HSN) sold more than \$1.7 billion worth of jewelry, cosmetics, and clothes, almost all of it ordered by remote-control-waving TV watchers who placed their orders by calling HSN's 1-800 numbers. Diller's discussions with the Microsoft brass that Sunday afternoon culminated in USA

Network's estimated \$1.5 billion purchase on July 16 of the software giant's majority stake in online travel site Expedia Inc., making Diller the Internet's largest travel agent. "To call Barry Diller a Hollywood mogul just doesn't cut it anymore," says Arlen Kantarian, CEO of the U.S. Tennis Assn., which has broadcasting and merchandise fulfillment deals with USA.

As Diller sees it, the revenue model for the media business



◀ **USA NETWORK** The second-highest-rated cable network provides original and re-broadcast series, feature movies, and sporting events. Top programs include *Nash Bridges*, *Law & Order: Special Victims Unit*, and tennis' U.S. Open. It is seen in 82 million U.S. cable and satellite homes.

TYLECLICK Designer of commerce Web sites, primarily for (76% owned by USA).

styleclick

SCI FI CHANNEL Cable channel in 72 million homes features and original shows, movies, and special events focusing on sci-fi, horror, and fantasy programming. Next up, the Steven Spielberg-produced *Armageddon*, a miniseries about humans abducted by aliens, premieres.

USA FILMS An independent movie company making mid- and smaller-budget movies. Its big hits include *Twister* and *Being John Malkovich*.



▼ **STUDIOS USA** TV production and distribution company whose shows include *Law & Order*, *Xena: Warrior Princess*, and *The Jerry Springer Show*.



Trio

◀ **TRIO** An arts channel seen in 10 million digital cable and satellite homes.

There's plenty of skepticism about Diller's grand vision. For one thing, the concept of convergence has been on the radar for 20 years and counting. Yet fewer than 5 million U.S. homes today are equipped with interactive TV boxes, according to Forrester Research Inc. "The record so far is poor for getting folks to shop for more than just pizzas and other smaller impulse items," says Forrester analyst Josh Bernoff. "Shopping by TV was supposed to take over TV back in the 1980s," adds Arthur Gruen, president of media economic consultancy Wilkofsky-Gruen Associates. "We're still waiting."

There's also no shortage of criticism among fellow media moguls about Diller's vision. "Obviously, we disagree," says Jamie Kellner, a former Diller associate and now chairman of AOL's Turner Broadcasting System Inc. "Those are the assets Barry's got, so he's out pitching him." Indeed, this is the third time since 1998 Diller has re-focused the company around its shopping assets, following failed attempts to buy the NBC network and to merge with Internet portal Lycos.

Today, Diller concedes USA is "a second-tier" media company. Its two largest outlets, the USA and Sci Fi cable channels, reach no more than 1 or 2 million viewers at a time, a far cry from the tens of millions of viewers larger rivals like NBC or CBS can attract. That raises the possibility that Diller's shopping services or cable channels could be squeezed from TV dials in a world increasingly dominated by giants. The company has already had its first taste of that: In early

▶ **CRIME.COM**

A Web site and soon-to-launch digital cable channel focusing on crime-related programming.

CRIME

▶ **NEWSWORLD INTERNATIONAL**

TV and online provider of 24-hour international news and documentaries, currently seen in 7.3 million U.S. cable homes.



is shifting. Advertising dollars, which power the majority of such media giants as CBS parent Viacom Inc., are too unreliable to plan a business around, he says. The price of subscriptions, the lifeblood of media powerhouse AOL Time Warner Inc., can only be hiked so much. The media company of the future, says Diller, will increasingly have to rely on revenues from merchandise sales on TV and the Internet to offset the ever increasing costs of making TV shows and films.

U.S. OPEN: KATHY WILLENS/AP/WIDE WORLD; LITILL FROM TRAFFIC; BOB MARSHAK/2000 USA FILMS; LAW & ORDER: BENJAMIN ARMSTRONG ROBERTS

August, cable powerhouse AOL Time Warner moved USA to channel 40 from channel 23 on several of its systems, giving AOL's Court TV the favored lower channel slot. "He is clearly a small player in a world of giants," says cable titan John C. Malone, whose Liberty Media Group owns a 21% stake in USA Networks.

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Diller makes no secret of the fact that he's prowling for a major media property. He has a debt-free balance sheet and \$2 billion in cash. And the company's recent numbers show other signs of financial health. While other media companies have struggled with an advertising slowdown, USA Networks reported a 19.5% increase in revenues for the first half of the year, to \$2.7 billion, and a 13% increase in operating income, to \$157.4 million. Unlike other media companies whose stocks are in a slump, so far this year, USA shares are up about 30%. "No one is better positioned than we are," Diller boasts.

"SERIAL KILLERS." Clearly, the transaction assets he has assembled are impressive. Ticketmaster, which last year sold more than 83 million tickets, and dating service match.com, are leaders in their categories. With Expedia, Diller will create what may be the media world's first fully functioning converged entity. The travel site, his soon-to-debut USA Travel cable channel, and his Hotel Reservations Network Inc. Internet sites should sync together well. That kind of cross-promotion has USA pro-



BARRY DILLER

BORN Feb. 2, 1942, in San Francisco.

CHILDHOOD Family moves to Beverly Hills, Calif., where his father runs a real estate company. Neighbors include Doris Day and Danny Thomas.

EDUCATION Drops out of UCLA; begins to learn the entertainment industry as a clerk in the mailroom of William Morris Agency.

BIG BREAK Promoted to ABC's chief of programming in his 20s. Credited with creating movie of the week and the mini-series.

CAREER HIGHLIGHTS Becomes chairman of Paramount Studios in 1974; in 1984, joins with Rupert Murdoch and develops Fox into the fourth TV network. Takes control of Home Shopping Network in 1995 and buys USA Network in 1998.

SETBACKS Loses \$10 billion bidding war for Paramount to Viacom in 1994; two bids to buy NBC fizzle; deal to merge with Internet portal Lycos falls apart in 1999.

RITUALS Annual bike trip with Disney CEO Michael Eisner.

FAMILY Confirmed bachelor marries longtime friend Diane von Furstenberg in 2001.

jecting it will sell more than \$750 million worth of stuff this year on the Net, third among Internet companies behind Amazon and Priceline.

Diller intends to keep that momentum going with—what else?—more deals. "We're serial killers," he says. "Sometimes we can't stop ourselves." But what could slow Diller down is USA's Gordian knot of an ownership structure. USA has two large shareholders, French conglomerate Vivendi Universal, with a 43% stake, and Malone's Liberty Media. Either company could block him from striking a deal larger than \$2 billion. In fact, it was Vivendi vice-chairman Edgar Bronfman Jr. who blocked Diller's bid to buy NBC in 1998, fearing the deal would dilute his family's stake in USA.

But this time around, Diller's two largest shareholders may step out of the way if the USA chairman brings them the right deal. Vivendi Chairman Jean-Marie Messier is eager to find distribution for the films and music produced by his company's

Universal film studio and record company (page 82). He had O.K.'d Diller's \$4 billion bid earlier this year for Rainbow Media, which owns Bravo, American Movie Classics, and other cable outlets. But Diller pulled out rather than engage in a bidding war.

Nevertheless, Diller needs to move fast. Even

with a huge first-mover advantage, Diller faces a media world that is quickly beefing up its ability to process merchandise and sell tickets. Cable giant Comcast Corp., which owns HSN's much larger rival, QVC, has made no secret of its aim to add households with its \$40 billion bid for AT&T's cable unit. AOL is also likely to delve even deeper into the transaction business, and on July 23 invested \$100 million in Amazon.com with an option to buy the rest of the online retailer. NBC, with a 40% stake in shopping channel ValueVision International Inc.,

recently announced it was re-branding as ShopNBC. After the network promoted it on-air, ShopNBC's revenues grew to an estimated \$500 million this year from \$107 million in 1997. "We plan to be one formidable commerce engine for the peacock network," says Gene McCaffery, ShopNBC CEO.

Undeterred, Diller is sticking to his plans and seems willing to run the back office for now. In his view, media companies and advertisers will soon be beating a path to his interactive door. And the line, albeit a small one, is already forming. Hiring out its vast capabilities, including more than 12,000 folks manning phones and 40 warehouses and fulfillment centers around the country, USA Networks units run online commerce sites for the National Football League, the National Basketball Assn., and Sportsline, 20% owned by CBS.

So how do the disparate pieces of Diller's empire fit together? Diller can

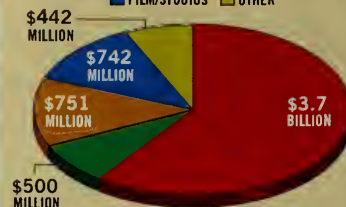
point to his July 16 accord with the Professional Golf Assn. as a convergence showcase. USA Network will broadcast the early rounds of many PGA events through 2007. USA's Ticketmaster will sell tickets, and USA's e-commerce folks will operate PGA.com, selling golf shirts and equipment housed at and delivered from Home Shopping Network warehouses. And even when final rounds are telecast on NBC or CBS, the PGA site will be heavily promoted, funneling folks from other networks to the USA-run Web site. "It's a full-circle vision for us," says Donna Orender, a senior vice-president at PGA Tour Inc.

Deals like these surely aren't of the scale Diller is used to. But Diller acts no less the entertainment mogul. To give USA's various holdings a slicker, more Hollywood appeal, for example, Diller recruited from his former staff at Fox. Both USA Cable President Steve Chao and Mark Bozek, president of Home Shopping Network, once made TV shows for Fox. Diller himself, though, still sets the creative tone for the

USA's COMMERCE MACHINE

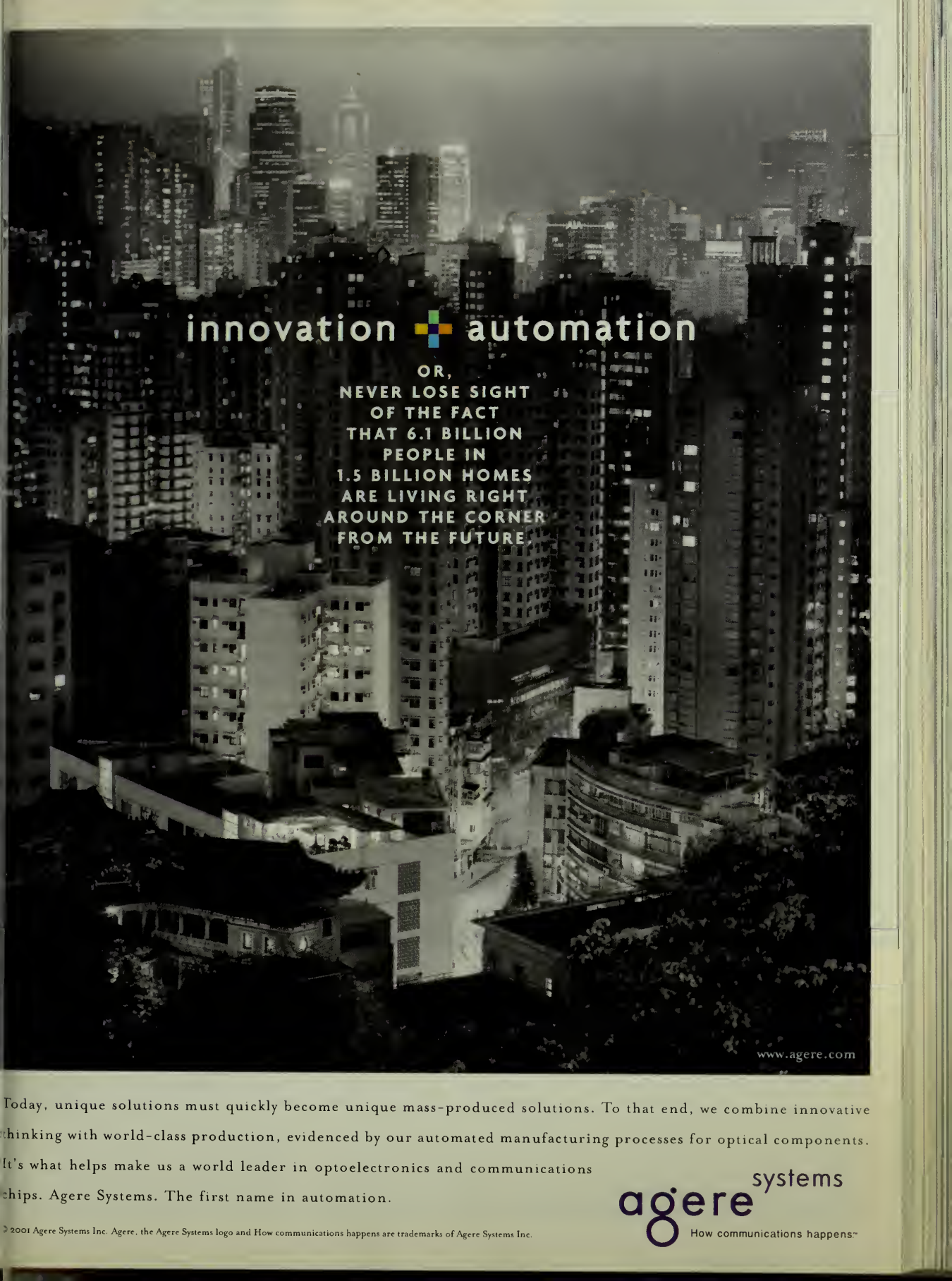
ESTIMATED 2001 REVENUES
TOTAL: \$6.1 BILLION

■ COMMERCE ■ SUBSCRIPTIONS ■ ADVERTISING
■ FILM/STUDIOS ■ OTHER



*INCLUDES ALL REVENUES FROM EXPEDIA, HOME SHOPPING NETWORK AND MAJORITY INTERESTS IN TICKETMASTER, HOTEL RESERVATIONS NETWORK, AND STYLECLICK.COM

Data: USA Networks Inc., SG Cowen Securities



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company. The USA chief executive is famous for dashing off streams of e-mails. Jetting between Los Angeles and New York almost weekly, Diller attends most idea meetings, and his input isn't always gentle. Recently, he spent a half-hour debating over the type size on a push-button for a new Web page. Ticketmaster had de-

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signed. "The meeting was confrontational and aggressive," says Ticketmaster CEO John Pleasants. "But in the end it was all about making that push-button better for the consumer. That's what Barry brings to these decisions."

Diller recently hired British programmer Michael Jackson, chief executive of Channel 4, to run USA's film and TV production operations. That move will likely free Diller to go back to scouring the landscape for the perfect deal. These days, he is said to be rummaging through the Internet bin, sizing up Amazon.com and Priceline.com Inc., both of which he has passed on before. Another hot prospect is film studio MGM. For much of the last year Diller and MGM Chairman Alex Yemenidjian have talked merger, but Diller so far has been unwilling to offer a high enough price. Such a deal would give Diller access to MGM's library of 4,100 movies and stakes in 14

cable channels, including Bravo and American Movie Classics. Then, the scuttlebutt goes, Diller would make yet another bid for NBC or Yahoo! Inc.—maybe both—to create an ever larger company. Diller and Yemenidjian won't comment.

Can the one deal be far away that will transform Barry Diller's sturdy little retailing operation into a major media player? As media giants fast consolidate, Diller risks being left behind. "There are only so many seats at the table," says SG Cowen Securities Co. analyst Ed Hatch. While few companies can match his ability to take and fulfill orders, it won't be long before media rivals can do much of that themselves. Diller admits that "giant tectonic" plates are moving around him and the landscape will be vastly different a year or two down the road. The man who invented the movie of the week knows a dramatic moment when he sees one. His best transaction may be still be ahead of him.

*By Ronald Grover in Los Angeles
and Tom Lowry in New York*

BusinessWeek online

For more on the Hollywood scene, see Ronald Grover's Power Lunch column at www.businessweek.com/today.htm

WHITE KNIGHT OR THORN IN BARRY'S SIDE?

It didn't take long for Vivendi Chairman Jean-Marie Messier and Barry Diller to get chummy. Within three weeks of Vivendi announcing last June that it was buying Seagram Co. for \$34 billion, Messier jetted off for an introductory sit-down with Diller at Los Angeles' Four Seasons Hotel.

Vivendi would be taking over Seagram's 43% stake of Diller's USA Networks Inc., and the intriguing subplot was that Diller's white knight had finally arrived. Under Messier, Paris-based Vivendi would help Diller realize his long-held goal to buy TV network NBC or some other large media property. "We're all learning French as quickly as we can," joked Mark Bozek, CEO of USA's Home Shopping Network, at the time.

A year later, it seems Messier needs Diller at least as much as Diller needs the 44-year-old former investment banker. Already, they talk at least weekly. And Messier is moving to New York, where Diller spends half his time. That raises the question of how cozy might be too cozy for Diller, who has fallen out with nearly every media exec he has worked with—from Rupert Murdoch to Paramount Communications Inc.'s

Martin S. Davis. "At this point in his life, Barry doesn't want to work for somebody else," says SG Cowen Securities Co. analyst Ed Hatch.

LEG UP. Messier's challenge is to ratchet up the newly named Vivendi Universal to offer a wide array of e-commerce and interactive enter-

tainment over Canal+, its European pay-TV network, and Vizzavi Ltd., its European wireless Net portal. Suddenly, USA Networks' shopping, ticket, and travel businesses look like a leg up—especially for Vizzavi, which faces tough rivals. What's more, USA Networks has a proven track record in e-commerce; Vivendi does not. And Diller might just help Vivendi get

a foothold in the U.S. cable or satellite markets. "Having USA in the family makes it that much easier for them," says Merrill Lynch & Co. analyst Neil Blackley.

As for Messier, he believes he can help Diller speed USA's global growth by offering him rich new outlets for those businesses. About 10% of USA's estimated revenues of \$5.5 billion this year is expected to come from overseas. Messier says one way to boost the numbers might be Canal+,

whose 15.3 million subscribers make it Europe's No. 1 pay-TV operator and a possible new outlet for USA's Home Shopping Network.

Beyond those plans, just how far will the synergy stretch? Canal+ still doesn't have the upgraded set-top boxes to provide the range of interactive services Messier envisions. Vizzavi, a joint venture between Vivendi and cell-phone operator Vodafone Group PLC, has repeatedly delayed its rollout in Europe because Web-enabled, next-generation cellular handsets aren't yet widely available. Even when it's up and running, Vizzavi will face stiff competition from portals such as Yahoo! Inc. and European Net giants such as Deutsche Telekom's T-Online International.

Stateside, of course, Messier is well aware of Diller's importance, particularly as Vivendi's eyes and ears for deals to strengthen its U.S. distribution. That might be why he is looking to hug USA Networks even tighter. He is in talks with dealmaker John Malone about a stock swap that would boost Vivendi's ownership of USA from 43% to 63%. Messier says taking a greater stake in USA is a good investment and not meant to breathe down Diller's neck. "He's the guy who makes the decisions," he adds. But to Barry, he could seem like just another meddlesome boss.

By Tom Lowry in New York, with Carol Matlack in Paris and Ronald Grover in Los Angeles



MESSIER: Synergy?



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THE VISITORS FROM A PARALLEL UNIVERSE HAD KNOWLEDGE. BUT NOT LIKE THIS.

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LICENSING

'WHOA, COOL SHIRT.' 'YEAH, IT'S A PEPSI'

More companies are using licensing to extend their brands

Like many other companies, PepsiCo Inc. has never been averse to making "logowear" emblazoned with its brands for the right promotional opportunity—say, Pepsi-Cola T-shirts to be tossed into the crowd at soccer games. But Eli Harari, CEO of apparel maker AmeriCo Group, had greater ambitions in mind when he approached the Purchase (N.Y.) company last year: to create a line of young men's and women's apparel, footwear, and accessories that would serve not as a crude brand billboard but rather reflect the "lifestyles" of Pepsi and Mountain Dew drinkers. "This is not typical promotional license stuff, to stick a logo on a cap and give it away at an event," he says. "The product has to be right even without the label."

Judging by what has emerged so far from the deal signed in March, Harari and his new client are taking that precept literally, reading trendy lines of young men's apparel for next spring that will rarely display more than a wordless Pepsi or Mountain Dew icon tucked away on a tag. The partners hope to move millions of dollars of apparel, while making the brands central to active youngsters' lives.

"CASH AND CACHET." Pepsi's not alone among big marketers in taking a larger view of licensing, allowing outsiders to pay a royalty to create and sell products under the mother-ship brand. They see licensing as a way to extend their brand into new categories and build awareness of the core line. In a softening economy, it doesn't hurt that licensing is a rare brand-building vehicle that generates revenue rather than



POP POWER: The Pepsi logo is almost invisible on this line of clothing

requiring big outlays as ads do—bringing both "cash and cachet," says Jong Yang, director of North American licensing at Timberland Co. The outdoor footwear company is launching a licensed kids' wear line in the U.S. in the fall of 2002 and is considering selling outdoor equipment under its name. Licensors typically get about a 10% cut of sales above a minimum guaranteed payment.

As a result, corporate licensing is no longer just a low-level activity, run by minor-league executives concerned only with plastering the company name and logo in as many places as possible. Now, "it's seen as a strategic tool to enhance the brand while giving a meaningful revenue stream," says Seth M. Siegel, co-founder of licensing agency Beanstalk Group Inc., which represents Harley-Davidson, AT&T, and Coca-Cola. Recognizing that, agency giants such as Young & Rubicam Inc. are moving to set up

their own licensing operations. Beanstalk was wooed by several agencies before agreeing to be acquired in June by Ford Motor Co. Now it analyzes the licensing potential of Ford trucks, Jaguar cars, even Hertz rentals. Overall, corporate licensing surged 10% in 2000, to \$98 million, according to the International Licensing Industry Merchandisers' Association.

A few companies, such as AT&T, are even betting that licensing can help shift consumers' perceptions of their brand.

As AT&T pushes into broadband and wireless services, it wants to shed its familiar but bland image by finding partners who can put the brand into cutting-edge digital products while handling the manufacturing and research and development, says Sari Lipson, vice-president for brand asset management. The phone giant has just launched a line of AT&T-branded CD-ROMs produced by Verbatim Corp. and is eyeing products from baby monitor

to a universal TV remote control.

For all its promise, licensing still carries risks. Licensors must find manufacturing partners that will uphold the company's quality standards. They also have to come up with items retailers can sell. Licensees who have been burned on faddish entertainment properties such as the movie *Godzilla* are more receptive now to tried-and-true brands. Another concern: The economic malaise could stampede companies into emphasizing revenue generation, returning to the bad old days of proliferating tchotchkes that are inappropriate for the brand image. AT&T admits to having made that mistake with generic-looking \$3 calculators sold at Staples.

The bottom line is that companies need to be disciplined enough to nix the wrong offers. Deere & Co., with a thriving business in die-cast replicas of its farm equipment, drew the line at an apparel maker's idea of producing purple polyester shirts, says Jeffrey T. Gredvig, director of corporate brand management. The choice of material would have provoked cotton growers, who are major buyers of Deere gear. Rejecting that one, Gredvig says, was a no-brainer.

By Gerry Khmerouch in New York

REACHING FURTHER OUT

AT&T has launched a line of CD-ROMs



AT RISK: A GOLDEN OPPORTUNITY IN BIOTECH

Limits on federal funding have already eroded U.S. research efforts

For decades, the U.S. has been the world leader in biotechnology. It conducts more than 90% of the world's biomedical research, and U.S. federal and private spending on the sciences exceeds that of the rest of the world put together. But on Aug. 9, President Bush limited federal funding for stem cell research to cell lines already in existence. And on Aug. 27, a consequence of that decision became clear: The National Institutes of Health (NIH) announced that 48 of the 64 human embryonic stem cell lines eligible for U.S. funding reside in labs outside American borders.

That shows how far the U.S. has fallen behind in this promising area of biotechnology. While the U.S. continues

to debate the ethical implications, Britain, Scandinavia, and the Netherlands can lay claim to some of the top talent, a track record of public and private support, and a more liberal regulatory framework.

The U.S. once held the lead in stem cell research, when scientists at the University of Wisconsin became the first to isolate human embryonic stem cells in 1998. Sweden now has 24 of the world's existing stem cell lines, compared with 20 in the U.S. And other countries, in both Europe and Asia, are revving up their own stem cell programs.

But these nations will be hard-pressed to duplicate what could be done with unrestricted federal funding in the U.S. Their research budgets are tiny compared with the \$18.8 billion that the

NIH will spend to fund biomedical research this year.

Meanwhile, major scientific problems remain unresolved: It will be at least a decade before any practical use is found for stem cells, the basic building blocks that are the progenitors of all other cells. And no one is sure how embryonic stem cells can be developed into specific tissues. But ultimately, these cells could hold the key for treatments for Parkinson's, stroke, diabetes, and a range of other deadly diseases.

The U.S. is not out of the running, of course. The limited funding approved by President Bush could produce interesting results, although it is unclear whether existing stem cell lines are adequate for the experiments that researchers want to

STEM CELL RESEARCH AROUND THE WORLD

 **GERMANY** Research is forbidden on German human embryonic stem cells but permitted on legally imported cells, and public funding is available for animal and adult embryonic stem cell research.

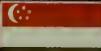
 **BRITAIN** Human stem cell research is permitted for therapeutic purposes, using embryos left over from fertility treatments. Cloning of embryos for therapeutic research is permitted, and a publicly funded bank of human embryonic stem cell lines is likely within a year.

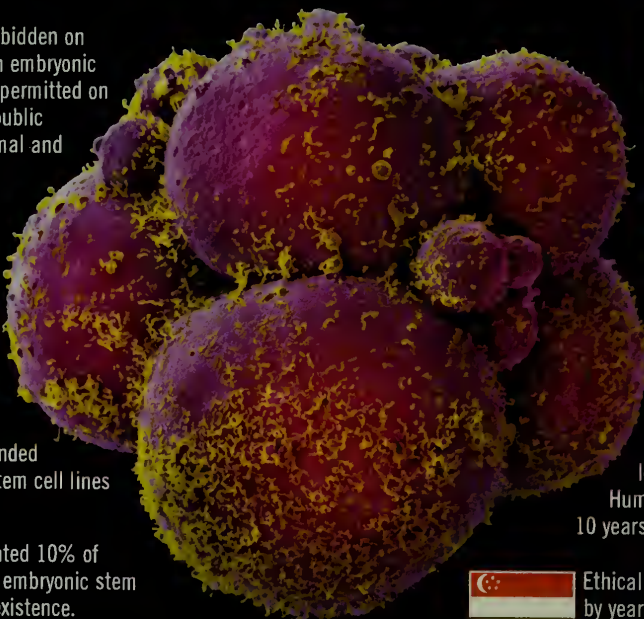
 **SWEDEN** Sweden has created 10% of the total human embryonic stem cell cultures in existence. Research is allowed on embryos left over from fertility treatments.

 **FRANCE** Set to introduce guidelines that permit human embryonic research for stem cell derivation but ban cloning.

 **ISRAEL** No formal laws and little public opposition. Researchers at two universities have created four stem cell lines and are working on deriving new ones.

 **JAPAN** Rules pending that will allow research on human embryos left over from fertility treatments. Human cloning punishable with up to 10 years in jail and fines of \$90,000.

 **SINGAPORE** Ethical guidelines likely to be introduced by year-end. National University of Singapore helped create six cell lines that are being commercialized by ES Cell International.



Science & Technology

do. And private research in the U.S. is largely unregulated and will continue. On Aug. 24, for example, the Howard Hughes Medical Institute said it will fund the procurement of human embryos left over from fertility clinics for Harvard University scientists to use to make new stem cell lines. Harvard scientists say they will distribute the lines free to all comers. Private companies such as Geron Corp., the leading biotech company involved in stem cell research, are also free to do as they please as long as they don't take federal funding.

TOO TINY. But private enterprises may be reluctant to share patented stem cell lines. Besides, Geron and the few other companies involved in this research are far too tiny to lead the charge. And few large companies are interested in joining the mission at this early, risky stage. "I can't tell you how many times I've given presentations to Big Pharma companies, but nothing really happens," says Dr. Evan Y. Snyder, a neurologist at Harvard Medical School and a leading stem cell researcher.

The leaders of stem cell research are increasingly found in Europe, with Britain in front. As the home of both the world's first test-tube baby and Dol-

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ly the sheep—the first mammal cloned from an adult—Britain has an established reputation in embryology and fertility. British researchers pioneered much of the early work on mouse embryonic stem cells two decades ago. And in January, Britain became the first country to introduce legislation allowing research on embryonic stem cells derived from both surplus and cloned embryos. The

latter, known as therapeutic cloning, "has put Britain on the moral and policy cutting edge," says Arlene Judith Klotzko, British lawyer and bioethicist and the author of *The Cloning Sourcebook*.

It's not just Parliament that's supportive. Britain's Wellcome Trust, the world's largest medical charity, with an annual budget of \$1.3 billion, is considering funding a British government plan to create a bank of human embryonic stem cell lines sometime next year.

Even Geron is moving research to Britain. Two years ago, Geron, which controls the rights to five stem cell lines in the U.S., bought Roslin Biomed, Scotland, a spin-off of the Roslin Institute, which cloned Dolly. There are now some 20 Roslin scientists working on Geron-funded stem cell research. "We had always intended to invest more [in the future] in response to the very receptive environment in Britain and the fact that public money might be available," says Geron Chief Financial Officer David Greenwood.

In the rest of Europe, biotech investors in the \$44 billion venture-capital industry are scouting opportunities. Both Scandinavia and Britain have thriving venture-capital communities. In Sweden,

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venture capitalists backed one of the country's first stem cell companies, NeuroNova, in 1998. After raising \$7 million in venture capital in 1999, Britain's ReNeuron Holdings PLC became the first European stem cell company to go public. Based in Guildford, ReNeuron, which uses embryonic stem cells from the tissue of aborted fetuses to repair damaged brain cells, raised close to \$30 million in an initial public offering.

RUMORS. Public funding sources anticipate a surge in grant applications for embryonic stem cell research. "We are definitely going to be putting more money into this area, but it's still too early to say how much," says Chris Higgins, director of the Medical Research Council's clinical science center at London's Imperial College School of Medicine. The MRC, which is funding former University of California at San Francisco scientist Roger Pedersen at Cambridge, has a program to recruit the best and brightest international scientists, offering two-year grants of more than \$2 million, plus research expenses.

The program has rumors swirling in the international scientific community about prominent U.S. researchers moving to the more hospitable shores of Britain. "As an academic scientist, if you want to improve methods of deriving embryonic cells, then Britain is bet-



ter," says Dr. Robin Lovell-Badge, head of developmental genetics at the National Institute for Medical Research, Britain's equivalent of the NIH.

Britain is clearly supportive. Its Biotechnology & Biological Sciences Research Council has spent close to \$28 million on embryonic stem cell research since 1989, the vast majority on mice. Now that the research is legal on human embryos for therapeutic and not just reproductive purposes, that amount is likely to increase rapidly,

WELL-FUNDED: *ReNeuron* raised \$30 million in an IPO

says Alf Game, head of genetics and biochemistry at the research council.

Still, few scientists in Britain and elsewhere want to see their U.S. peers shut out. If federally funded research drops off in the U.S., companies there "would be handicapped, as there wouldn't be the normal collaboration between the private and public sectors that has been responsible for so many important scientific advances," says Dr. Martin Edwards, CEO of ReNeuron. For stem cell researchers, those advances are far more important than any national pride of place.

Should the U.S. "stop funding this research, it will seriously and adversely affect prospects for human health for the next 100 years," says William A. Haseltine, CEO of Human Genome Sciences Inc. in Rockville, Md., and a renowned biotech researcher. If so, the U.S. will have lost more than its leadership position.

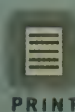
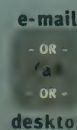
By Kerry Capell in London, with Catherine Arnst in New York, Arlene Weintraub in Los Angeles, and bureau reports

A related story begins on page 88.

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COMMENTARY

By Catherine Arnst

STEM CELL SCIENCE NEEDS MORE FROM UNCLE SAM

In the late 1960s, Barnett Rosenberg, a professor at Michigan State University, was conducting experiments to determine if electromagnetic energy could stop the growth of *E. coli*. By pure accident, he discovered that platinum from the electrodes stopped cell growth in the bacteria. Rosenberg brought his discovery to the National Cancer Institute, whose scientists did all the work to turn it into a drug and conducted all clinical trials. Ultimately, Michigan State, which held the patent, licensed it to Bristol-Myers Squibb Co. for marketing. That drug, cisplatin, was approved in 1978 and remains one of the most effective cancer drugs ever.

The story of cisplatin is a case study of the value of basic research done for the joy of discovery rather than the sake of the bottom line—and illustrates why so many scientists are dismayed about President George W. Bush's recent decision to place restrictions on federal funding of stem cell research.

DEEP POCKETS. The U.S. government has long had the world's deepest pockets for basic scientific research. But the White House ruled that scientists would have access to that money only if they limit their research to 64 human embryonic stem cell lines already in existence. Many scientists fear that these restrictions will slow progress to a crawl in this promising area of medicine. "Basic science is the only way to do it," warns Robert S. Langer, professor of chemical and biomedical engineering at Massachusetts Institute of Technology. "It's absolutely essential that we have government-funded research, and let's face it, most of the important research comes from the U.S."

Plenty of countries might argue otherwise, but they would certainly agree that their annual research budgets don't come close to matching the National Institutes of Health's

2001 outlay of \$18.8 billion. There is still the private sector. But commercial enterprises have never shown much interest in funding expensive basic science that won't pay off for decades—if ever—and stem cells are no exception. Rochelle K. Seide, a patent attorney who heads the biotech practice at BakerBotts LLP in New York, says she knows of no large pharmaceutical company doing work in this area. And, she adds, the small companies that hold patents on

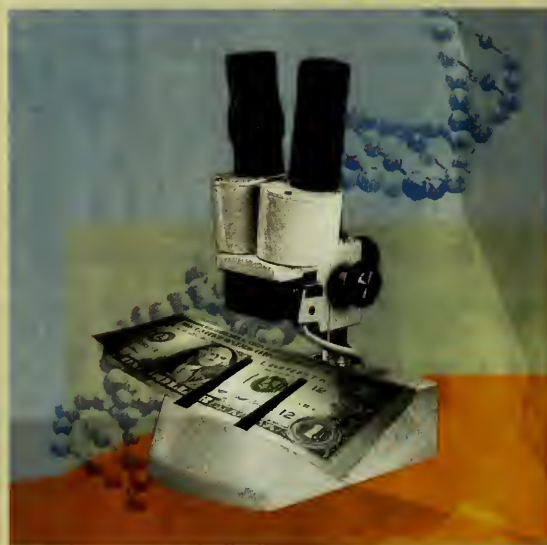
That's not surprising. If a commercial enterprise is going to spend the hundreds of millions of dollars required to derive a viable commercial product from a stem cell line, it would not be inclined to share its discoveries. "If all this work moves to the private sector, that means any positive data will not be available to other scientists for years," says Dr. Evan Y. Snyder, an associate professor of neurology at Harvard Medical School. "And the public may never hear about negative data."

EXORBITANT. And then there's the question of profit. It'll be at least a decade before any therapy based on embryonic stem cells is ready for human trials, and those could take another 10 years or more. It already costs from \$150 million to \$500 million to bring a new drug to market; most of those, like cisplatin, were based on basic research done in university or government labs. If stem cell research works, the resulting therapy "will be exorbitantly expensive because companies will need to recoup their investment," says Snyder. "Only the rich will be able to afford it."

A case in point is Novartis' breakthrough new cancer drug, Gleevec. Unlike cisplatin, Gleevec was developed completely by the company over 10 years. The drug finally reached the market in May—at a price to the patient of \$2,300 per month.

The solutions to most of the world's most vexing scientific problems are far too large for any one company, or government, to solve. The human genome would not have been deciphered in a decade without the support of the U.S. government, for example, and stem cell research is much the same. Let's hope the President rethinks his position before too much time is lost.

Senior Writer Arnst covers science and medicine for BusinessWeek.



LONG SHOT It's unlikely that businesses will fund basic research or share cell lines

stem cell lines are unlikely to do broad-ranging studies. "If they are interested in cardiovascular therapies, they won't be doing neurological research."

Nor, says Seide, is it likely they will license their lines to potential competitors. Already, two of the private companies that developed some of the 64 stem cell lines approved by the NIH, CyThera Inc. of San Diego, and Reliance Life Sciences P.V.T. Ltd. of Bombay, have said they are not willing to make them generally available just now.



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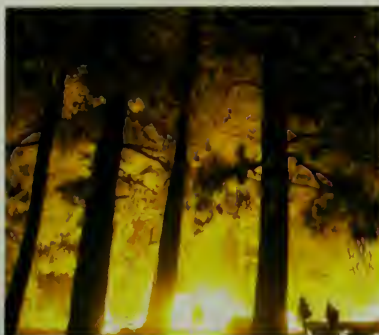
Developments to Watch

EDITED BY PAUL RAEURN

AN EYE IN THE SKY TO HELP SNUFF FIRES

FIREFIGHTERS WHO are battling wildfires across the western U.S. have a lofty new tool to help plan their attack. A sensor package on NASA's recently launched Terra satellite is the first dedicated to picking up fire outbreaks. By providing data to help the U.S. Forest Service's 25,000-plus firefighters and their equipment, the system should aid fire managers in extinguishing fires more effectively, says Tom Bobbe, a manager of the Forest Service's Remote Sensing Applications Center in Salt Lake City.

Previously, fires were tracked by airplanes and weather satellites. But planes work only for local, detailed re-imaging—they can't cover state-size areas. And weather satellites are designed to show cloud images, not ground de-



tails. The new MODIS system—short for Moderate Resolution Imaging Spectroradiometer—was developed by NASA to be especially sensitive to the thermal, infrared energy given off by wildfires.

NASA scientists and geographers at the University of Maryland developed the software that translates MODIS data into accurate maps. The resulting images are refreshed every night, and twice-daily updates aren't far off. If you want to keep track yourself, the maps are available online at www.nifc.gov/fire-maps.html. *Adam Aston*

TOWARD PAIN-FREE MAMMOGRAM?

EVERY YEAR, 45 MILLION women have a mammogram. Any one of them would tell you that the procedure is painful. Add to that anxiety over the amount of radiation used in the procedure, and it's easy to see why some choose to skip the test.

Now that could change. Louis E. Rivelli, CEO of Denver-based Fischer Imaging Corp., says the company has developed a system that offers higher resolution while working faster, reducing pain, applying less pressure to the breast, and using just 60% of the radiation of conventional film-based methods. And by eliminating costly film and developing chemicals, Fischer's SenoScan digital system would

be cheaper to operate. One drawback is that each machine costs about \$475,000, more than twice the price of traditional devices.

The SenoScan isn't the only digital system to make such claims. A similar device hit the market last November. But Fischer says its SenoScan offers better resolution and clearer images.

Cancer experts aren't ready to endorse the new system yet. "While it's desirable that women go through lesser pain and radiation, there isn't enough body of work to determine the benefits of the new digital systems," says Joanne Schellenbach, spokeswoman for the American Cancer Society.

Company officials say that the Food & Drug Administration is only weeks away from final approval. *Pallavi Gogoi*

BATTLING 'BAD' CHOLESTEROL WITH A NEW TEST

NEARLY HALF OF ALL ADULTS in the U.S. have abnormally high cholesterol, putting them at risk for the nation's No. 1 killer, heart disease. Quantimetrix Corp., a Redondo Beach (Calif.) maker of diagnostic tools, has developed a lab test that can identify levels of particular forms of cholesterol more quickly than traditional tests—enabling doctors to tailor treatments to individuals. The test, called the Lipoprint System, is the first Federal Drug Adminis-

tration-approved product that measures cholesterol in each of seven categories of LDL, or "bad" cholesterol.

The test can also be used to select the best treatment for patients with high cholesterol, because some drugs are more effective than others at targeting small, dense LDL.

Still, Lipoprint won't be an easy sell. There are no official guidelines for devising therapies based on levels of small, dense LDL. "There is a growing interest in this," says cardiologist Sidney Smith, chief scientific officer for the American Heart Assn., "but we need more studies." *Arlene Weintraub*

COZIER FORMATIONS FOR JETS

WHEN THE MILITARY'S PRECISION FLYING TEAMS PUT ON a demonstration, pilots often nestle their fighter jets within two or three feet of each other as they roar by in formation. Engineers at the University of California at Los Angeles think they can do better. Much better.

After years of work with NASA, researchers at UCLA's School of Engineering & Applied Science have developed a computerized gadget that should allow aircraft to safely fly just inches apart. The device, carried on each plane, takes readings of the planes, measuring velocity and attitude as well as data from the global positioning system. Blending the information, the computer then calculates where each aircraft will be and adjusts courses accordingly to keep the planes in tight formation. In a July test on a solo F-18 fighter—using computer simulations of other aircraft—the equipment was found to be accurate to within 2 in.

Why the focus on such cozy flying? By traveling in a snug V-formation, planes encounter less resistance, because the trailing aircraft can "hide" behind the leader as they speed through the air. And that means they burn up to 20% less fuel, which could mean big savings for air-cargo haulers. The trick, however, is to fit the trailing aircraft in the center of the lead plane's tiny vortex, which the UCLA engineers have found is about the size of a basketball. The team next plans to test its invention on a pair of F-18s flying together. *Michael Arndt*



EXECUTIVE SUITE

AN EMPIRE TREMBLES

Can a new generation of Pritzkers halt the slide in the family's fortunes?

For Penny S. Pritzker, the 42-year-old firebrand who is carving out a leading role in her family's multibillion-dollar empire, this year should have been a time of triumph. Her nationwide network of upscale retirement communities, multifamily housing developments, and office park complexes has been growing like kudzu. She expects soon to break ground on a \$350 million, 40-story office tower in the heart of Chicago to house her family's main businesses, the Pritzker Organization and Hyatt Corp. To top it all off, the fitness buff can still run circles around her male cousins, averaging about 8½ minutes a mile in a recent half-marathon.

But this year may go down as one of the worst ever for the ambitious Penny Pritzker and her storied Chicago family. The collapse of Superior Bank, a \$2.3 billion thrift that Pritzker chaired from 1989 to 1994, is putting the family's business savvy under the klieg lights in Washington and beyond. Profits are

under pressure at its 203 Hyatt hotels—it owns 34—all across the world, just as the Pritzkers map out final plans for a controversial \$1.2 billion development project along Boston's waterfront. And a major engine of the family's wealth, its \$7 billion-a-year Marmon Group Inc. industrial and financial conglomerate, is sputtering in the manufacturing downturn as questions arise about who will succeed Marmon Chief Executive Robert A. Pritzker, one of the architects of the Pritzker fortune, who turned 75 this year.

The distress is a crucial test of the leadership skills of a triumvirate of Pritzkers who now oversee much of the family's vast holdings. Penny, her cousin Thomas, and Nicholas, their first cousin once removed, have been on their own since the death of family leader Jay A. Pritzker in 1999. For the first time, they are now being called on to protect the mostly private, \$12 billion-a-year family business. How the Pritz-

kers handle their current woes will determine just how big a legacy they leave. Unlike other modern-day billionaire aires such as Warren E. Buffett and William H. Gates III, the Pritzkers intend to pass on the family fortune to the next generation. "The Pritzkers are golden," says Jonathan L. Kempner, chief operating officer of the Mortgage Bankers Assn. and an acquaintance of Penny's for a decade. "This is the first big stumble they've taken."

The Pritzkers' challenges are also a object lesson in just how difficult it ca-

THE FAMILY BUSINESSES

The Pritzkers own or manage companies with estimated revenues of \$12 billion a year

REAL ESTATE

Developments include Fan Pier, a \$1.2 billion Boston multi-use project. Classic Residence by Hyatt operates 18 retirement communities and Pritzker Residence owns more than 14 apartment units.



PENNY PRITZKER



THOMAS PRITZKER



NICHOLAS PRITZKER



to take control of a business dynasty. By letting New York real estate developer Alvin Dworman, a longtime friend and partner of Jay, have a free hand at Superior, they failed to grasp the problems there, which federal regulators describe as "poor lending practices, improper recordkeeping and accounting, and ineffective board and management supervision." Rather than pushing for a tighter focus in the manufacturing operations that their elder relative, Robert, has been running since 1953, they've tolerated weak returns from the

almost arbitrary collection of businesses. And by continuing to concentrate on the fickle upscale hotel and convention business, they've all but missed out on the explosive growth of lower-end hotels.

The Pritzkers, one of America's wealthiest families, have eschewed the limelight ever since the patriarch—the first Nicholas Pritzker—came penniless to the U.S. from Russia in the late 1800s, earned a law degree, and launched the family's ventures. His sons Abram and Jack, also lawyers, expanded the family's interests with smart Chicago-area real estate deals. Abram's sons, Jay,

Donald, and Robert, bought into Hyatt and other businesses. Today, the Pritzkers readily affix the family name to arts and educational institutions they sponsor, and bestow the most prestigious prize in architecture. But they remain vigilant about their privacy. None of the Pritzkers would comment for this story, and several of the companies they invest in also refused to comment.

But the Pritzkers won't be able to keep their business to themselves much longer. Officials at the Office of Thrift Supervision and the Federal Deposit

Insurance Corp. (FDIC) are attempting to unravel the failure of Superior Bank, based in Hinsdale, Ill., which they took over from the Pritzkers and Dworman on July 27. The savings bank collapsed after the owners and regulators couldn't come to terms on a recapitalization plan made necessary by the deterioration in Superior's subprime loan base over the past two

years. Indeed, the whole subprime segment is under stress as the economy weakens. The Pritzkers and Dworman, who each had a 50% stake in the thrift, had proposed pumping in as much as \$355 million in new capital. But as recalculations of the bank's problem assets piled on more red ink, the Pritzkers pulled back. Their attorney, Harold S. Handelsman, who had been a director of the thrift's holding company, describes Superior as "a black hole of uncertain numbers and unknown losses."

"MISERABLE JOB." Just who erred and what went awry with the thrift remains murky. But with as much as \$500 million in FDIC insurance funds at stake, the efforts to fix blame could get quite messy. Already, the dueling regulatory agencies have been faulting one another for lapses in oversight. And the Pritzker and Dworman camps have been conducting opposing stealth campaigns to tar each other or auditors Ernst & Young. Penny's friends say an "inevitable generational disconnect" with her Uncle Jay's colleague made it difficult to oversee his associates and led her to step back. For their part, people close to Dworman deride suggestions by the Pritzkers that they were "passive" investors. Dworman declined to comment. Meanwhile, everyone is bracing for lawsuits. "These are wealthy, sophisticated people," says Bert Ely, an independent banking consultant who has been tracking Superior's decline. "As businesspeople, they did a miserable job." In response, a source close to the Pritzkers says: "The Pritzker board members and those representing Mr. Dworman relied on unqualified opinions of its auditor. Superior Bank was highly rated by the regulators as recently as 1999. Hindsight is 20/20."

No one has suggested that the Pritzkers gained improperly at Superior, but their supervision almost certainly will be deemed inadequate. Dworman

HOTELS

family owns all or part of 34 hotels and 23 units under development, including Regency, Grand and Park Hyatt.

Marmon Group, which includes Trans Union, the credit-reporting giant.

OTHER INVESTMENTS

Among others, a 25% share with a partner in Royal Caribbean Cruises and stakes in a managed-care outfit and an online education concern.

INDUSTRIAL

\$7 billion-a-year

representatives have dominated the bank since he and Jay bought it in 1988; Dworman officials had far more intimate dealings there, including taking a \$100 million loan from the bank's holding company. But Pritzker Organization officials unquestionably have been involved all along. Penny took the chairman's position in 1989, four years after earning her law and MBA degrees simultaneously at Stanford University. She quit in 1994, but as of July, she was still a director of the thrift's holding company, Coast-to-Coast Financial Corp. So, too, were Pritzker attorney Handelsman and Glenn Miller, a financial manager for the family who chaired the bank's audit committee.

TOUGH-MINDED. For Penny, a largely titular position and tolerance of lax management seem out of character. She oversees the extensive residential and commercial real estate interests of her family, outside of Hyatt and its other hotels, and runs a luxury retirement community unit, Classic Residence by Hyatt, that she started. She's responsible for operations in at least 11 states, ranging from several thousand apartment units and modest commercial developments to master-planned communities. By all accounts, she's tough-minded but modest and as demanding of herself as she is of others. "She's the quickest study and the clearest thinker I've ever met," says Robert J. Fitz-



PENNY PRITZKER

AGE 42, 4th-generation cousin

EDUCATION Lawyer and MBA

POSITIONS Former chairman, now defunct Superior Bank; heads Classic Residence by Hyatt and Pritzker Realty Group

BIGGEST CHALLENGE Contending with legal fallout from collapsed Superior Bank

OTHER COMMITMENTS Board member, William Wrigley Jr. Co.

AFTER HOURS Former chairman of the Chicago Museum of Contemporary Art; active in several Chicago civic efforts; competed in marathons and recreational ski races.

patrick, director of Chicago's Museum of Contemporary Art, whose board Penny chaired until recently.

She hasn't been afraid to wield her legal savvy on others' behalf. In 1997, when the Museum of Contemporary Art tried to collect a \$5 million pledge that a former chairman balked on, Penny pushed the matter into court and then brokered a settlement. In the end, the museum accepted a contribution of two paintings instead, which today are valued together at about \$7.5 million.

Penny Pritzker is also one of the most overtly political members of her family—a stance that could help her as the Superior case winds its way through Washington. She has contributed \$189,000, mostly to Democrats, over the past few years, including \$100,000 to the Democratic National Committee in 2000. She helped her younger brother, Jay Robert "J.B." Pritzker, run unsuccessfully in the 1997 Democratic con-

gressional primary in Chicago. In all, the family has given some \$666,500 to members of both parties since 1996.

Beyond Superior Bank, other parts of the Pritzker empire are showing their weak spots. It wasn't until last fall, for example, that Hyatt diversified into the fast-growing lower-end of the hotel business by acquiring the franchisor of Motel Inns & Suites. The family finances are strong enough that they could start buying up distressed properties. But for now, Hyatt remains highly exposed to the falloff in business travel, since most of the hotels it manages or owns fit into the so-called upper upscale category. Hyatt Corp. doesn't release financial data, but a person close to the company says its profits are likely to slip from record setting levels in 2000 to the still healthy range they reached in 1999. Profits in the segment industrywide are expected to slide 8.6% this year, according to PricewaterhouseCoopers. Thomas Pritzker minced no words in June at New York investment conference, saying "The summer will be fairly miserable."

Diminished returns at Hyatt aren't the only problem for Thomas, 51. He also is a board member of Royal Caribbean Cruises Ltd., where the family and partners hold a 25% stake. And the value of that—worth as much as \$2.6 billion in January, 2000—has plunged to about \$1.1 billion. The problem: Royal Caribbean and its rivals have been putting more ships into the water just as demand and pricing have started sinking. Net income for the cruise line is expected to drop to about \$333 million this year, from \$445 million last year; even a sales rise from \$2.87 billion to \$3.28 billion, according to Credit Suisse First Boston analyst Scott Barry.

Although these responsibilities keep Thomas Pritzker busy enough, he has made something of a side career out of



WORRIED DEPOSITORS

THOMAS PRITZKER



AGE 51, 4th-generation cousin

EDUCATION Lawyer

POSITIONS Chairman, Hyatt International and Hyatt Corp.

BIGGEST CHALLENGE

Profits at Hyatt are sliding as business travel slows

OTHER COMMITMENTS Board member, First Health Group Corp.,

Royal Caribbean Cruises Ltd., Bay City Capital

AFTER HOURS Serves as vice-chairman of the Art Institute of Chicago; published photographs and commentary on Buddhist and Hindu art from Nepal



IN SHANGHAI: THE GRAND HYATT

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his interest in Asia. He has chaired the Art Institute's committee on Asian art and photographed and written about 8th-century Nepalese art. In 1999, he played host in Chicago to Chinese Premier Zhu Rongji, presenting him with a 1,500-pound black Angus bull and a Chicago Bulls basketball jacket.

The faltering economy and the Pritzkers' predilection for staying in the background are complicating one of their most ambitious and contentious new development projects: the nine-building Fan Pier project in Boston. When Nicholas J. Pritzker, 55, who heads Hyatt Development Corp., first presented his plan, he was attacked in the Boston press as a carpetbagger with no concern for the city's precious harborfront. In recent months, he has repeatedly downsized the plan to meet the concerns of conservation and environmental activists. The mixed-use site was once expected to house two Hyatt hotels; now that's down to one. Nicholas also cut the height of planned towers, moved them back from the river, and increased open space. His flexibility has drawn praise even from a critic at the Conservation Law Foundation. But staff attorney Seth Kaplan still faults Nicholas and his cousins for taking far too low a personal profile: "If they could stand up and say, 'We've played an important role in Chicago in creating good public spaces, and we want to help do that in Boston,' that would be a very welcome message."

FAN PLAN. Nicholas must have been particularly galled to be criticized as insensitive to the environment. The soft-spoken lawyer doesn't eat meat, is a fervent collector of dinosaur bones, and is so keenly interested in cosmology—the study of the origins of the universe—that he sponsored a symposium on the subject in 1999. "He's passionate, he's no dilettante," says Michael S. Turner, who chairs the Astronomy & Astrophysics Dept. at the University of Chicago.

Even though the family finally has a plan in place, Fan Pier will be built much more slowly than they had hoped. Instead of a target date of 2007, it may now take the Pritzkers until late in the decade to complete construction. First, key government approvals are still pending. And though capital contribu-



NICHOLAS PRITZKER

AGE 55, 3rd-generation cousin

EDUCATION Lawyer

POSITIONS Chairman of the board and CEO, Hyatt Development Corp.; directs Hyatt's casinos and timeshare operations; CEO, Hyatt Equities

BIGGEST CHALLENGE His huge \$1.2 billion develop-



RENDERING OF FAN PIER

ment project in Boston, Fan Pier, met with much opposition and had to be scaled back

OTHER COMMITMENTS Chairman, Eos Biotechnology Inc.; director, Bay City Capital, a private merchant bank

AFTER HOURS Collects dinosaur bones; sponsors high-level symposiums on cosmology

tions should not be a problem for the relatively underleveraged Pritzkers, raising funds from partners could take a while. Hyatt Equities LLC, the family-owned entity that has bought up Hyatt properties, was downgraded a notch, to a BBB debt rating last year, by Standard & Poor's Corp., which, like *BusinessWeek*, is owned by The McGraw-Hill Companies. The issue, says S&P analyst Craig A. Parmelee, is "continued development spending and our expectation for a slowing economy."

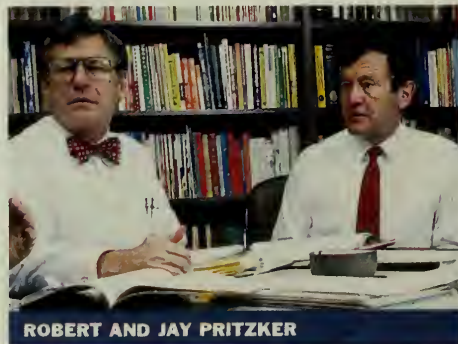
Perhaps the biggest financial ques-

tions for the family are about its largest but lowest-profile, business operation: the Marmon Group. Robert A. Pritzker and his brother Jay put together the diverse collection of businesses that range from credit-reporting giant Trans Union to copper-tubing manufacturer. But Robert has no obvious successor from within the family and he is not talking about his retirement plans. "Bob has a succession plan, always subject to being updated, to continue that good management," a Marmon spokesman says. "He sees no benefit in publicly giving into the details."

Succession is particularly important now at Marmon, however. The manufacturing recession that has idled assembly lines all across America in the past year has hit the company hard. Even as sales climbed 3.9%, to a record \$6.8 billion last year, the outfit's earnings plunged 14.2%. The group has produced only lackluster earnings since the mid-1990s, posting mostly single-digit profit rises. The problem: Synergies seem elusive in a group of more than 150 companies with little in common. "We can hope this downturn will be short-lived," Robert told employees in a newsletter in April, "but we can't depend on it."

The Pritzkers can only hope that all their current troubles will be fleeting, a brief spasm rather than the beginning of a decline in their fortunes. The family is looking to Penny, Nicholas, and Thomas to put the problems many of which they inherited behind them. The challenge is to match the boldness of their father without repeating their missteps.

By Joseph Weber in Chicago
with Lorraine Woellert
Washington



ROBERT AND JAY PRITZKER

A PRITZKER FAMILY TREE

NICHOLAS PRITZKER

Arrived penniless in the U.S. from Russia in the late 1800s, earned a law degree, and set up a successful law practice.

ABRAM, JACK PRITZKER

Nicholas' sons, also lawyers, expanded into smart Chicago-area real estate deals.

JAY, DONALD, ROBERT PRITZKER

Abram's sons, they bought into Hyatt and other businesses, largely shaping the empire that exists today. Only Robert, CEO of Marmon Group, is still alive; now a new generation of Pritzkers is in charge.



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COMMENTARY

By Catherine Yang and Tom Lowry

AOL TIME WARNER: AIMING TOO HIGH?

Is hubris hurting AOL Time Warner? In January, when the two finally tied the knot after a year-long regulatory logjam, Chairman Stephen M. Case and CEO Gerald M. Levin proclaimed that the one-of-a-kind union of New and Old Media would usher in the Internet Century. Its dazzling services would combine AOL's powerful online franchise with Time Warner's venerable media brands. With no less bombast, the executives thumbed their noses at the weakening economy, vowing that the new entity would easily generate \$40 billion in revenues and \$11 billion in cash flow in its first year.

Eight months later, it's time for a reality check. With the slowdown in ad, subscription, movie, and music sales, Wall Street has knocked 20% off the stock since its recent high of \$51 in May. On July 18 alone, investors pushed the stock down 10% in several hours after the company reported second-quarter revenues \$500 million shy of analysts' estimates. But if the market is sending a message, no one at headquarters is heeding it. And that could have repercussions with a Street that is increasingly merciless when companies miss their numbers.

WHAT IF? AOL Time Warner Inc. still insists it will make good on its ambitious promises. But it remains bullheaded at its peril. Consider the worst-case scenario: By sticking to increasingly unrealistic targets, the company sees its vision of supersynergy fade in a haze of disappointing profit reports. Shareholders begin to see the marriage as just two companies clinging to each other to mask slowing sales, rather than as a match-up of winners. Expectations aren't managed, and a drop in stock price leads to the loss of the company's cachet and eventually higher costs to raise equity and debt. The result? AOL Time Warner loses the

ability to invest in new technologies and make strategic acquisitions to fulfill its dreams.

Of course, AOL Time Warner is far from that scenario today. But investors are already scratching their heads over its self-stated goals. "The ramp-up to hit its numbers is just too high," says Ajay Mehra, a portfolio manager at Columbia Management, the unit of FleetBoston Financial Corp. that sold 2 million of its 6 million AOL shares in May. They weren't alone: A handful of AOL's top brass also took the

of 12% to 15% revenue growth, at \$40 billion. But they insist they'll meet the expected 30% growth in so-called EBITDA, or earnings before interest, taxes, depreciation, and amortization, by which media companies measure performance. Meanwhile, AOL Time Warner is making a mad dash to meet its targets. "We're on a maniacal path," says Pittman. On Aug. 21, the AOL division announced 1,700 layoffs on top of 2,400 job cuts already announced by the parent. Reaching for new revenue, AOL Time Warner is also launching a unit to of-

TOUGH TARGETS

Meeting AOL Time Warner's 2001 growth goals will be difficult

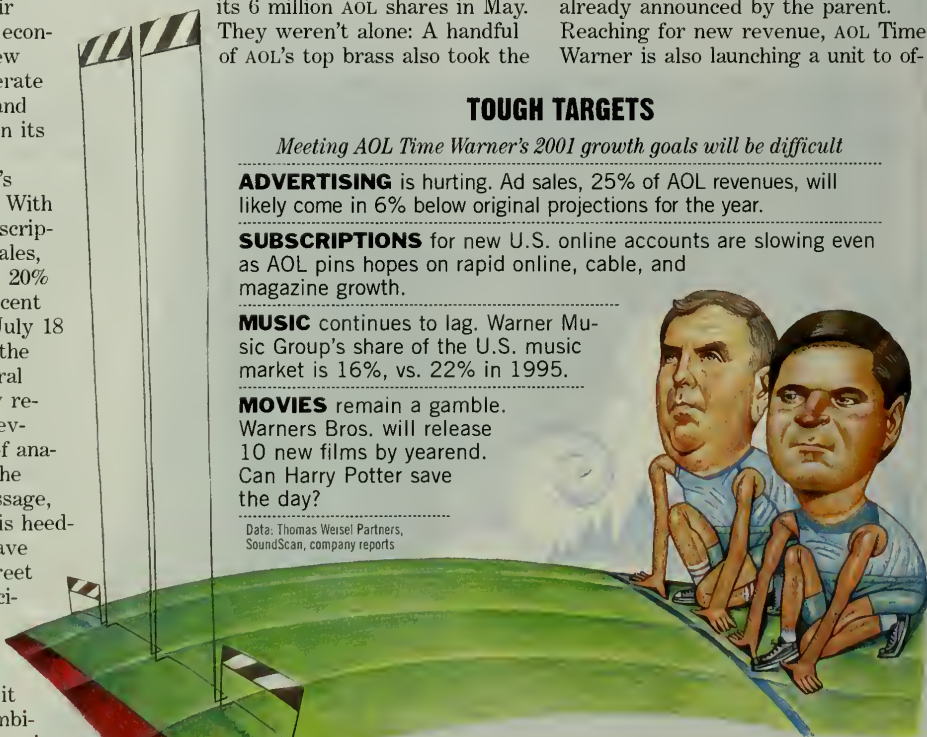
ADVERTISING is hurting. Ad sales, 25% of AOL revenues, will likely come in 6% below original projections for the year.

SUBSCRIPTIONS for new U.S. online accounts are slowing even as AOL pins hopes on rapid online, cable, and magazine growth.

MUSIC continues to lag. Warner Music Group's share of the U.S. music market is 16%, vs. 22% in 1995.

MOVIES remain a gamble. Warners Bros. will release 10 new films by yearend. Can Harry Potter save the day?

Data: Thomas Weisel Partners, SoundScan, company reports



opportunity to sell high. Case, Co-Chief Operating Officers

Richard D. Parsons and Robert W. Pittman, Executive Vice-President Kenneth B. Lerer, and Vice-Chairman Ted Turner sold off a total of nearly \$60 million worth of AOL holdings, not including stock options they exercised, according to Securities & Exchange Commission filings. A spokesperson says the selling is part of their long-term financial planning.

Case and Levin concede they will come in a shade below their pledge

for ad clients one-stop shopping across print, TV, and the Internet. And it's creating an interactive arm that aims to cash in on video-on-demand and interactive TV if and when that market takes off.

But "they cannot squeeze more blood out of this stone," says Charles Crane, co-investment officer at Victory SBSF Capital Management, which holds 1.5 million AOL shares. True, AOL Time Warner, which generates about 25% of revenues from advertising, 40% from subscriptions, and 35% from content, such as box-office and

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STOCKS

music sales, is more diversified than many other media outfits. But every segment is now under attack. U.S. ad revenues are expected to decline 4% this year, according to *The Myers Report* media newsletter. Music sales could slump 5%, says Kagan Worldwide Media. And media merchant bank Veronis Suhler & Associates figures U.S. film box office sales may inch up only 2%, vs. 7.2% in 1999. Even subscriptions, AOL Time Warner's stalwart earner, may slow as the rate of new U.S. online subscribers levels out.

All this may remind investors that before merging, AOL and Time Warner were both slowing down in growth. AOL knew its astronomical gains couldn't last forever. Indeed, new AOL subscribers will grow by only 18% next year, vs. 23% this year, says Merrill Lynch & Co. And it doesn't help that Microsoft Corp. will be pushing the rival MSN online service with the fall release of its XP operating system. AOL's hookup with Time Warner helps hide those trends. "AOL ducked out of danger at the most incredibly opportune time," says Jupiter Media Metrix Inc. analyst Mark Mooradian.

For its part, Time Warner needed to boost anemic growth with high-performing acquisitions. After it bought Turner Broadcasting Systems in 1996, a \$191 million net loss turned into profits of \$246 million a year later. But the Turner channels CNN, TBS, TNT, and others are maturing, so Time Warner is betting on AOL for a shot in the arm.

Because perception is reality on Wall Street, any erosion of AOL Time Warner's go-go expectations could do real damage. If investors see a partnership of two slowing businesses instead of an Internet-media juggernaut, they are more likely to question management at every turn. The company will have less leeway to do the tough work of making convergence a reality. AOL Time Warner shouldn't squander the excitement generated in the first year of the merger with missteps on the Street.

Technology Writer Yang and Media Editor Lowry cover AOL Time Warner.

DEAR ABBY, YOU GOOFED

How Goldman's pundit might answer investors—and what she sees ahead

EDITOR'S NOTE: Abby Joseph Cohen, the formerly prophetic Goldman, Sachs & Co. investment strategist, updated her stock market outlook Aug. 21, slightly lowering her target a second time this year and slashing her too-high estimates of earnings. Later, she spoke with Associate Editor David Henry about her calls. Using words from the interview and her reports, here is how she might reply to hypothetical letters from disgruntled investors:

Dear Abby:

My problem is you. I used to trade stocks every time you said something about the market. And since you never said anything really bearish, the only thing between your words on the tv and my buying more stocks was a click of my computer mouse. I made a lot of money. No more. Mar. 7, 2001, was the last day I'll ever take your advice. You said then to put more money in stocks. The S&P 500 was at 1254, and you said it would go to 1650 by yearend, up 32%. The other day, Aug. 28, it was at 1162, down 7%. I should have known you didn't have the inside line in late 1999 when you grew quiet while the Nasdaq had another 40% of upside.

You're no different from other salesmen on Wall Street. I don't care if you

sound like an authority, talking about "this" and "we that." It must have been dumb luck that made you bullish early in the 1990s and then stubbornness that kept you that way for so long. When you pounded the table for tech early on, was probably just to make a name for yourself. I'd bet on that before I'd bet S&P will be up 29% to 1500 by Year's, like you're saying now.

Furious in P.

**ABBY
JOSEPH
COHEN**



Dear Furious:

We understand your frustration. We all wish we knew exactly what lies ahead. We give us credit for having Wall Street's second-lowest price target for 2000, a target that proved to be successful. And let's not forget that we advised getting out of tech in March, 2000, and moving into energy, real estate investment trusts, and pharmaceuticals. All generated positive returns in 2000.

Our price targets are meant to be precise. We provide them to offer a sense of direction and magnitude over coming months. They are derived primarily from our forecasts of corporate earnings.

Without question, however, our annual estimates for 2001 earnings were high. A more accurate view would have given us a more accurate—and realistic—view of stock price performance. Our original estimate for operating earnings was \$61.50

re, later revised to \$56.50 and 1. The second quarter was like-worst ever for earnings. Mea-conservatively, they declined the scale of the disappointment ed many people.

Abby:

years, I was impressed by the work you and your staff devote to ing corporate accounts and learn-ow much companies are truly g before you make projections. diligence put you a cut above strategists. But your earnings eses have proven so wrong you t as well have made them up. s, now it looks like you missed a warning while you had your head e books. Did you not see how 1 of the growth in earnings was ng from sales of technology, par- arly telecom equipment paid for money raised in the bond and k markets?

Disappointed in Dubuque

r Disappointed:

ve still think the accounting scrub do on financial reports and our eco-ic analysis set us apart. Remember t at the beginning of 2000, our S&P nings forecast was the lowest on e Street. We were very much out the consensus. We were one of the 7 who correctly thought that there ould be a dramatic deceleration in e economy. We took a lot of criti- m, and we heard from our clients. In prospect, our 2000 estimate was very se to the actual result.

We did see the enormous borrowing r telecom service companies, and we ent a lot of time talking to our clients out it. We thought it was a major isallocation of capital. We had it in ind as part of what we called "the ark side of Y2K," our expectation that ech sales would slow after so much oney was spent in 1999.

What we misjudged was how long it ould take for the earnings deceler- ion to run its course. We thought hings would look better by the middle f 2001. We were surprised by the weakness of the economy and the charges taken by many companies.

We have never seen such aggressive use of accounting as corporations are using this year. In some cases, they are throwing in the kitchen sink.

Dear Abby:

I can't believe you are complaining about accounting games. For years, you told us the quality of reported earnings was improving. It was one of your reasons to believe the bull market. Now companies admit they weren't earning what they said when stocks were going up. Looks like you got hoodwinked, too.

Payne N. Portfolio

Dear Pain:

For some companies, that was the case. We did, however, begin to express some concern about accounting issues over the last year or two. But we still believe the overall quality of earnings has been dramatically enhanced by low inflation. And companies now give us more information and in greater detail, thanks to actions by the Financial Accounting Standards Board and the Securities & Exchange Commission over the last three years.

Now, companies may be overstating how bad the situation is. The SEC told companies a few months ago to issue

long-range estimates of charges. Some have announced enormous adjustments for potential layoffs and inventory reductions. To the extent these do not occur, current earnings may be understated and future earnings may benefit.

Dear Abby:

I see you've gotten yourself on the wrong side of a lot of people lately. What have you learned?

Bob in Tupelo

Dear Bob:

The mistake I made was not being more cautious on stocks when I realized that our earnings estimates were so much below the consensus. I should have anticipated stocks would suffer more from the disappointment. Second, which we have taken to heart, is the need to delve into the earnings numbers more, really pushing the analysis.

Dear Abby:

I always say everyone deserves another chance. And I still want market advice. Please try again.

Patient in Peoria

Dear Pat:

Thank you. We see earnings rising in 2002 about 10% from 2001, based on a moderate acceleration in the economy and help from some special factors. Those include new accounting standards, the decline in energy costs, and the projected decline of the dollar. Many industries will benefit from on-going productivity improvements.

While the poor earnings results and disappointing share-price performance continue to weigh on investor sentiment, we believe this will fade. Our price targets of 1500 on the S&P at the end of 2001 and 1550 in mid-2002 are likely to be achieved in 2002.

Dear Abby:

How does it feel to blow the bear market call and your chance to be immortalized as a great strategist?

Wondering in Santa Monica

Dear Wondering:

I am an analyst, and I do the best job I can. I'm not going to be infallible, but we try to get it right more often than we get it wrong.

ABBY'S STREAK TURNS COLD

FEB. 1991 Amid recession, with Dow near 2700, she turns bullish, foresees benefits of technology.

NOV. 1995 Dow at 4870. She says stocks and economic expansion have "a long way to go."

OCT. 1996 Dow at 6000. She predicts another 1000-point gain.

DEC. 1996 Dow at 6400. Fed Chairman Greenspan's "irrational exuberance" spooks market. She says stocks are 5% undervalued.

OCT. 1997 Dow at 7161, down 14% amid Asian crisis. Buy more stocks, she advises.

SEPT. 1998 Dow at 7539, down 19% amid world financial crisis. Again, buy more stocks.

DEC. 1999 Dow at 11,225. She sees 12,300 in 12 months.

DEC. 2000 Dow at 10,794. She calls for 13,000 by end of 2001.

AUG. 2001 Dow at 10,320. She expects 12,500 by end of 2001.

MORTGAGES

NOT EVERYBODY LOVES A REFI BOOM

Mortgage servicers and investors who back them may be at risk

Falling interest rates have been a boon for homeowners, who have happily fueled one of the largest refinancing booms in history. In the first six months of 2001, 2.5 million borrowers traded their mortgages in for lower-rate loans, and things aren't slowing down. After dropping in July, refinancings are expected to jump again for August.

But the flurry of activity is putting

other hand, fall in value as refinancings increase because interest on the loans will be paid over a shorter time than expected. When rates fall rapidly, holders of 10s get clobbered. About \$40 billion in 10-related securities is traded on Wall Street.

Now, some analysts and investors say the recent drop in 30-year mortgage rates to below 7% could trigger a new

To mitigate their risk when rates go down, these outfits rely on hedging. They purchase pos and other financial instruments that generally gain in value when rates fall. Demand for pos, for example, shot up late last year, as companies anticipated rate cuts. To gauge how effectively proper hedging can help a company, just look to Countrywide Credit Industries Inc., based in Calabasas, Calif. In the fourth quarter of 2000, the company took a \$740 million charge to revalue its mortgage servicing portfolio, but investors didn't blink—because the charge was offset by a pos and derivative hedge that brought in \$698 million.

DEBACLES. Deciphering a company's exact hedging strategy is tough. After all, many consider the nuts and bolts of their hedging operations proprietary information. To date, there have been



LOWER RATES, MORE LOSSES: As refinancings increase, the value of some mortgage-backed securities goes down

increasing pressure on companies and investors that rely on a steady stream of mortgage payments for income. Topping the list are mortgage servicers, which get fees for collecting and processing payments on loans. When a homeowner refinances his or her loan, the principal is paid back to the loan's owner but the servicer loses out on expected fees. In July, the sixth-largest servicer, HomeSide Lending, Inc., based in Jacksonville, Fla., took a \$450 million charge because its servicing portfolio shrank. Although refinancings have rocketed industrywide, the company has been unable to pull in enough new loans to balance the losses.

Also at risk are investors in some of the \$3.8 trillion in outstanding mortgage-backed bonds. Home loans are bundled into securities on Wall Street, and some are carved into investments known as 10s, or "interest only" securities, and pos, or "principal only" securities. When rates go down and homeowners refinance in droves, principal payments on the loans are made sooner, driving the value of pos up. 10s, on the

round of refinancings, and perhaps a new crop of losses. "Someone with a huge exposure could get a nasty surprise," predicts Michael McMahon, a Sandler O'Neill & Partners financial analyst. Huge exposure is the name of the game for the top 10 mortgage servicers, which now handle nearly 50% of the country's home loans, up from 25% in 1995.

The Top Mortgage Servicers

DOLLAR AMOUNT OF MORTGAGES SERVICED (BILLIONS)	
1. WASHINGTON MUTUAL	\$469.4
2. WELLS FARGO HOME MORTGAGE	462.5
3. CHASE MANHATTAN MORTGAGE	409.1
4. BANK OF AMERICA	338.2
5. COUNTRYWIDE CREDIT IND.	306.1
6. HOMESIDE LENDING	187.4
7. GMAC MORTGAGE	178.0
8. ABN AMRO MORTGAGE	130.3
9. FIRST NATIONWIDE MORTGAGE	112.3
10. CITIMORTGAGE	100.5

Data: NNN/Quarterly Data Report

some spectacular debacles when investors have misstepped. In 1994, for example, a \$600 million fund invested in mortgage securities lost most of its value when the hedges it relied on failed. Using pos to hedge for falling 10 values isn't a perfect trade: Values of pos are undermined when delinquencies rise. If the economy starts to crumble, the hedge doesn't work. Already, some securities backed by low-quality mortgage loans, called subprime, are showing record-high delinquency rates.

Most mortgage servicers, though, insist there's no threat of large charges ahead. "It won't happen with us," says William A. Longbrake, chief financial officer at Washington Mutual Inc. The thrift has increased its mortgage-servicing portfolio 50% since the first quarter to become the largest in the business. "As the business consolidates, you've got more people who know what they're doing" under one roof, Longbrake explains. Perhaps, but under that same roof is more risk than ever before.

By Heather Timmon
in New York

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[ANOTHER REASON PSEG HAS WALL STREET'S ATTENTION]

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LENDING

BOEING CAPITAL HITS CRUISING SPEED

But the finance arm may be pitted against prime Boeing clients

Boeing Co. may not admit it, but its new finance unit aspires to be a GE Capital lookalike. Boeing Capital Corp. is moving aggressively to help its parent not only sell more airplanes and expand into aerospace but also move into financing such big-ticket items as oil rigs, barges, and cargo ships.

Boeing Capital was created nine months ago as part of Boeing's diversification strategy—one that closely mirrors the formula of General Electric Capital Services Inc.'s for combining manufacturing with financial services. Formerly a finance arm inherited from the merger with McDonnell Douglas Corp. in 1996, the new Boeing Capital is on a roll. Net income jumped 37%, to \$107 million, in 2000. Revenues soared 57%, to \$447 million; return on equity was a healthy 19.7%. The commercial-equipment (nonaircraft) financing division had its best year, generating \$710 million in new business, compared with about \$1 billion in new business for aircraft financial services. This year looks even stronger for both: Through June, net income climbed to \$81.3 million, up 107% from \$38.9 million last year. Add it all up, and Boeing Capital now provides about 5% of Boeing's net profits.

DILEMMA. But to grow from here won't be so easy. For one thing, the weakening economy threatens to reduce margins and pinch profits. More fundamentally, Boeing Capital faces a dilemma: To keep growing it must build up its fleet by buying new aircraft. That will put it in direct competition with other aircraft-leasing companies, who are already Boeing customers. "It would make it very tough

for us to buy Boeing aircraft," says Robert J. Genise, CEO of Boullion Aviation Services Inc., a leasing company. "It would put us at a big competitive disadvantage."

While Boeing Capital is modeled on GE Capital, it's a fraction of the size: Boeing's \$7.5 billion portfolio pales in comparison with GE's \$370 billion, which

ment. Palmer also sees new opportunities in commercial satellite financing—especially now that Boeing owns Hughes Satellite Co.

Boeing Capital officials say they are open to future acquisitions to grow. In fact, says First Union Securities analyst Sam Pearlstein, "if they want to be a serious player, they [must] make an acquisition." But there's still room for creative financing: Last year, Boeing Capital agreed to buy back British Airways PLC's 757 fleet for conversion into freighters and leased them to DHL Worldwide Express. With Hawaiian Airlines Inc. this year, Boeing Capital worked with leasing outfit Ansett Worldwide to help it finance the purchase of nine new 767 jetliners, worth about \$1 billion. Boeing Capital also helped Boeing Commercial Airplane

win a \$2.9 billion order from AmTran Inc.'s commercial air division, American Trans Air, for 47 Boeing jets in 2000. To close the deal, Boeing Capital agreed to help remarket the carrier's 24 aging 727s, go to International Lease Finance Corp. and GE Capital to supply cash for 17 of the new jets, and purchased \$50 million in AmTran preferred stock. "Boeing appears to have changed their modus operandi 180 degrees," says J. George Mikelsons, founder and chairman of AmTran. "I used to be that Boeing's answer to small carriers like ourselves was: 'Look, fellows, our job is to build airplanes and it's up to you to figure out how to finance them.'"

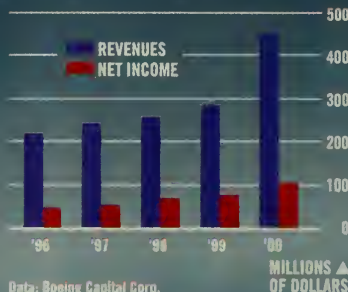
So far, these deals share common themes: They are riskier transactions that include equity stakes in the airlines and involve rival leasing outfits as partners. While Palmer has no plans to buy

new aircraft and move onto customer-leasing turf, concerns remain that he may alienate Boeing aircraft customers. Goldman, Sachs & Co. analyst Howard A. Rubel says Palmer can pull it off. "He is very deliberate, and he is very capable of balancing risk with opportunity." That may be so. But as he tries to expand, Palmer will have to face off with GE Capital and other leasing firms such as International Lease and CIT, a unit of Tyco International Ltd. That could mean turbulence up ahead.

By Stanley Holmes in Seattle, with Michael Arndt in Chicago

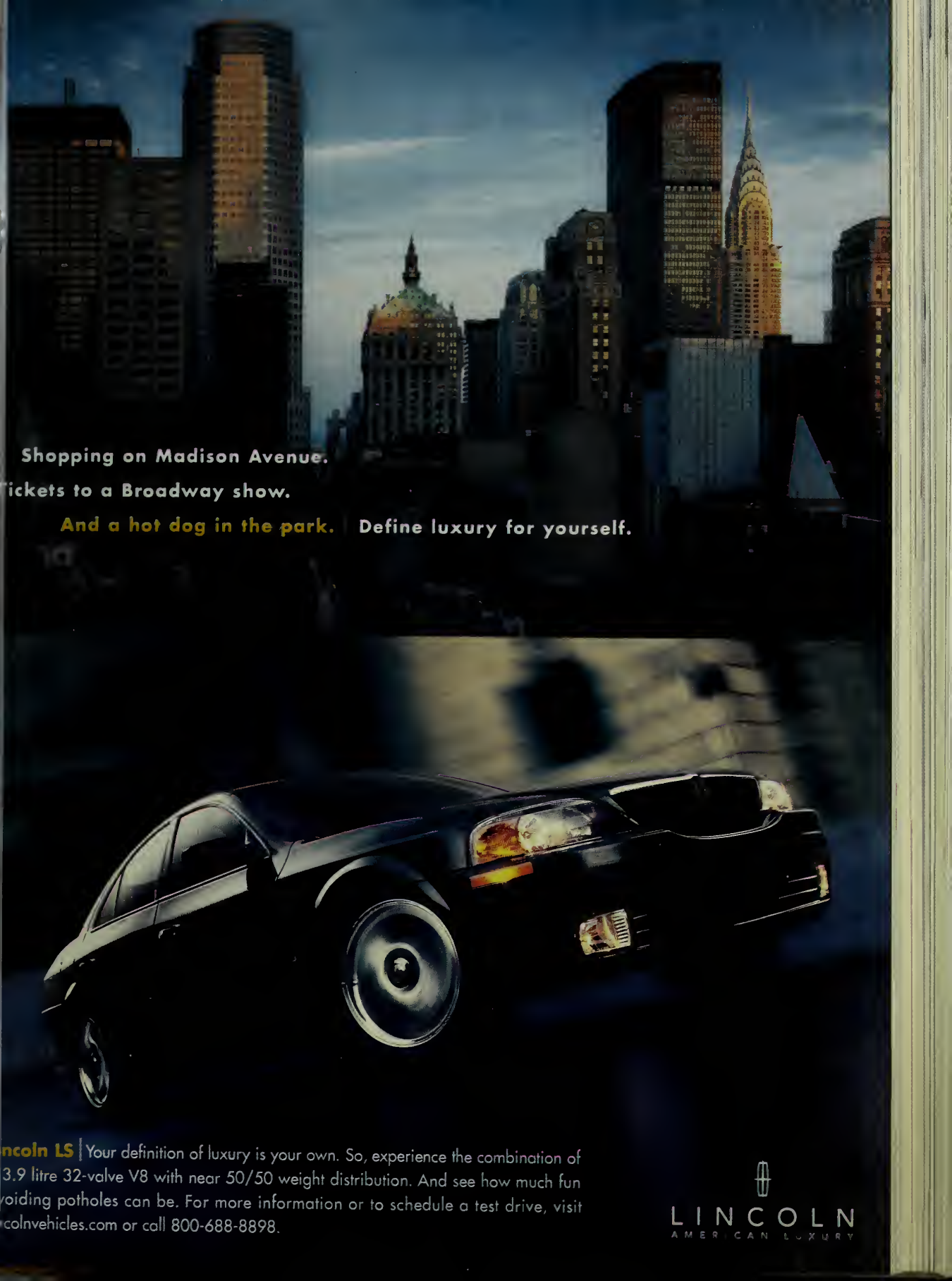
UP AND UP

Boeing Capital's revenues and profits soar



WAY PAST PLANES: Boeing Capital has moved into leasing gear such as dredges

was amassed by financing not only the jet engines that GE Aircraft builds, but also with expansions into consumer finance, reinsurance, commercial real estate lending, and aircraft leasing. "Clearly, we believe in the concept of a financial-service company," says Boeing Capital President James F. Palmer. "One doesn't have to look any further than GE to see what they have been able to do. The key question is: 'How do you grow at a profitable rate?'" The crux of its growth plan is to stick to financing airplanes and heavy equip-



Shopping on Madison Avenue.

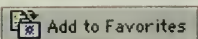
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*Companies that have filed for
bankruptcy since January, 2000,
and their assets:*

Data: Bankruptcydata.com; BW

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Electricity and natural gas

\$24.2
billion



1 BARON VULTURES

*Douglas Teitelbaum is among those (including Philip Anschutz
and Thomas Hicks) looking to build new empires with their buys*



THE **RETURN** OF THE WALL STREET VULTURE

Investors are risking
billions to buy up
the wreckage of the
U.S. economic bust

On Aug. 16, bankrupt wireless startup NextWave Telecom Inc. held a hastily arranged news conference before a packed crowd in a ballroom near New York's Grand Central Station. The topic was its master plan to build a high-speed Internet network across the U.S. The plan had been stuck in neutral since the venture first won its most valuable asset—wireless spectrum licenses—five years ago.

Few people noticed one of the most important men in the room, Douglas P. Teitelbaum, seated quietly in the back row. The

managing principal of Bay Harbour Management, a \$700 million vulture fund, had just thrown the troubled wireless venture a lifeline. Despite the meltdown in telecom stocks and a nasty fight with the Federal Communications Commission to keep the licenses, Teitelbaum, already the company's largest investor with a 6% stake, decided to bet that NextWave would someday become a major wireless player. So he led a group, including

Cover Story

MICHAEL LEWIS

other funds, UBS Warburg, and equipment maker Qualcomm Inc., that sank another \$5.5 billion into it.

Welcome to the Great American Fire Sale. Wall Street's vultures are buying companies and their assets at bargain prices on an unprecedented scale. Never before have so many troubled companies been on sale for so little. Nor have so many scavengers swooped in to take control of companies by snapping up bad loans and beaten-down bonds. Private equity firms, leveraged-buyout shops, vulture funds, hedge funds, and investment banks

Cover Story

have a war chest of about \$45 billion from the likes of private investors, pension funds, and college foundations to buy a chunk of the record \$592 billion worth of distressed and defaulted bonds and bank loans now on sale for \$360 billion, estimates Edward Altman at New York University's Stern School of Business (chart).

LITTLE LOVED. Unlike analysts and venture capitalists, who became media stars in the 1990s boom, Wall Street's vulture capitalists tend to shun publicity. Typically, they loathe discussing their investments for fear a rival might dive in and screw up a deal. And many hate being mentioned in articles like this. They're so shy because they know vultures are little loved. By reputation, they prey on corporate misery and wind up firing workers.

Their bad rap is often deserved. Some have shut businesses and liquidated entire companies just to collect the cash in the till. But the vultures have a crucial role in helping Corporate America recover from the excesses of the past decade. By providing shareholders and creditors with an exit from soured investments, they can set the stage for a new phase of economic growth. Using liquidity furnished by Fed Chairman Alan Greenspan's interest-rate cuts, they buy companies' assets at knocked-down prices. And that should allow an orderly liquidation of assets instead of a financial panic—or a freeze-up like Japan's, which has kept the world's second-largest economy in gridlock for more than a decade. "The whole bankruptcy system in the U.S. is designed to rehabilitate the corporation. You don't die for your mistakes. You get refinanced," says William C. Repko, head of J.P. Morgan Chase's restructuring group.

Not that the process is easy or without substantial risks. The last time the vultures were out in force, in the early 1990s, their big targets were busted real estate assets and ill-fated leveraged buyouts. Making money from them was a breeze compared with profitably cleaning up after last year's telecom meltdown—which has thrown up about half of the \$37.6 billion of defaults in the public bond market so far this year, according to NYU's Altman. For starters, investing in telecoms means placing bets on fast-changing technologies.

Just how tough the going has become is reflected in the average recovery rate on defaulted telecom bonds. That has plum-

meted to a meager 12¢ on the dollar—less than half of last year's 25¢. And even those levels could prove to be too high if the economy continues to stall. Indeed, some buyout artists are already seeing some of their investments plunge to as little as 2¢. "It used to be that you got at least 50¢," says Marc Lasry, senior managing director at broker Amroc Investments, which specializes in distressed companies.

Can the vultures beat these odds? Little academic study has been made of their impact. But Edith S. Hotchkiss, a finance professor at Boston College, found that companies taken over by vultures in the early 1990s performed better after they emerged from bankruptcy. "I expect the vultures' participation in governance [today] to be even more critical to the success of the reorganized companies," says Hotchkiss.

Already, the vultures' marauding is shaking up several industries. In telecom, Teitelbaum and others are stepping up pressure on wireless carriers such as Verizon Wireless Inc. by funding a rival—and keeping precious radio spectrum out of their hands. Reclusive Denver billionaire Philip Anschutz has gained sway over one out of five of America's 36,000 movie screens by buying up the debt of troubled cinema chains. And Thomas O. Hicks's leveraged-buyout shop Hicks Muse, Tate & Furst Inc. is stitching together a string of bankrupt brands—Swanson, Open Pit barbecue sauce, Vlasic pickles—to build a new franchise, Pinnacle Foods Corp.

Still others are preparing to pounce. Henry Kravis' Kohlberg,



2 FAST-BUCK VULTURES

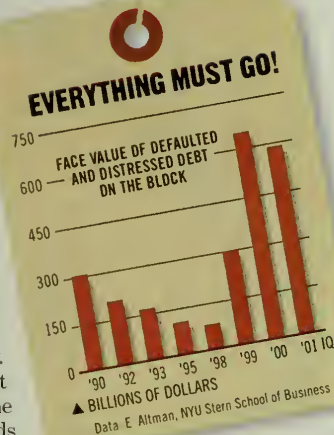
Howard Marks aims for a big payoff as quickly as possible. Other fast-buck players include Martin Sass and David Matlin

avis Roberts & Co. set up a venture with Accel Partners in July to buy out telecom players. Nelson Peltz, president of investment firm Triarc Companies Inc., who bought American Can in 1986 and distributes magazines in his office bearing his motto "cash is king," is once again shopping for cheap low-tech companies. Goldman, Sachs & Co. has raised \$1 billion for a private equity fund to acquire stakes in venture-capital and leveraged-buyout portfolios that investors desperately want to exit. And real estate titan Sam Zell, dubbed the "Rave Dancer," has started picking at distressed assets in telecom and elsewhere. "You have a lot of inefficient markets out there and a lot of companies reporting a lot of lousy numbers," says Zell. That's creating opportunities to buy various kinds of paper at relatively attractive prices." The predators don't all work in the same way. Some snap up debt and restructure companies just enough to sell their stakes at a profit. Call them the Last-Hope Vultures (even though some turnarounds take several years). Others, the Baron Vultures, patiently create new empires. Then come the passive mutual funds, pension funds, and hedge funds that are stuck with soured bets in their portfolios. These Last-Hope Vultures must metamorphose into marauders to recover at least a

portion of their investments—and avoid becoming bait themselves.

Serving them are the Hired Guns: traders who charge a fee to buy and sell the debt of troubled companies, crisis managers, restructuring advisers—financial repo men hired by banks to fetch a company's assets after it goes under—and bankruptcy lawyers. These days, they're in huge demand. While bankers are getting pink slips, many of the Hired Guns will get 20% pay hikes this year, according to compensation consultant Johnson Associates.

Here's how they work:



THE BARON VULTURES

Billionaire Anschutz, who started in the oil business, has remade himself into a movie tycoon in a year. He has been buying up the

debt of troubled movie-theater chains such as

United Artists Theatre Circuits and Edwards Theatres for as little as 60¢ on the dollar and swapping it for equity. Currently, he's locked in a battle with KKR and Hicks Muse for control of the nation's largest theater chain, Regal Cinemas.

So far, Anschutz has used his new clout to cut a deal with creditors to get United Artists in and out of bankruptcy. Next, media experts expect him to retool his theaters to show digital movies and host concerts. Anschutz, who declined to be interviewed, has a proven track record of striking gold in insolvent franchises. In the 1980s, he bought decrepit Southern Pacific Railroad and later used its rights of way to lay fiber-optic lines for his \$19 billion Qwest Communications International Inc.

Bay Harbour's Teitelbaum already sits on the board of a dynasty he helped rescue from bankruptcy—Barneys New York Inc. Teitelbaum first got involved with NextWave in 1996, when he lent it \$1 million. He then plowed in more money to keep it from going bankrupt. Once NextWave did go belly up, he bought its debt for as little as 20¢ on the dollar, bringing his total investment to about \$20 million as he fought the FCC for the company's right to keep its airwaves. "[Wireless data technology] is the brightest ray of hope for the telecom industry," he says. Teitelbaum figures NextWave eventually could be worth \$45 billion—quintupling the value of his stake to \$1.35 billion. Perhaps, but, warns one analyst, "that's a tough value proposition."

Money managers aren't alone in aspiring to become Barons. Entrepreneur John J. McDonnell Jr. joined with five other executives and private equity firm GTCR Goldner Rauner LLC in April to buy back his brainchild from bankrupt dot-com PSINet Inc. for \$285 million. In 1999, the high-flying Internet startup paid \$720 million for



LAST-HOPE VULTURES

Michael Dienst of CIBC World Markets negotiates for burned bondholders, including Scudder High Yield Fund

McDonnell's credit-card-processing business, Transaction Network Solutions. "It was like getting a car back with a few dents on it," says McDonnell. When the market improves, he wants to take TNS public. Andrew "Flip" Filipowski, chairman of Internet software and consulting firm divine Inc., is also buying battered pieces of dot-coms—considered the most treacherous area for vultures. In April, he bought parts of now-bankrupt marchFIRST Inc., whose chairman, Robert

Bernard, was once a divine board member.

The Barons' strategy is spawning other

imitators. Some big companies have started acting like vultures by bidding for bankrupt rivals at auction, accelerating consolidation. AMR Corp. bought TWA Airlines LLC in April. And Hewlett-Packard Co. is considering buying bankrupt Comdisco Inc. "Companies are increasingly interested in picking up bankrupt companies," says Henry A. Miller, head of the restructuring group at Dresdner Kleinwort Wasserstein. "Before, they were worried about touching them."

Cover Story

THE FAST-BUCK VULTURES

Howard Marks, chairman of \$20 billion vulture fund Oaktree Capital Management LLC, has no interest in gaining control of companies for the long run. He aims to earn a big payoff as fast as possible by buying the troubled loans of debt-plagued companies such as insurer Conseco Inc. and lender Finova at sizable discounts. "We are trying to buy a dollar for 50¢," says Marks, who operates from an immaculate white-marbled office overlooking downtown Los Angeles. "If you want cheap, you have to find it on the slag heap."

He's finding plenty of junk on corporate trash piles. Marks reckons that Oaktree is now the country's largest buyer of troubled bank loans, with \$2 billion in its portfolio. He's careful to spread his bets: Oaktree won't invest more than 5% of its funds in any one company. Marks also sticks to senior debt—bank loans and bonds that have the strongest claim to repayment—so he'll have a say in turnaround strategies and in how the assets are divvied up. This cautious strategy has racked up a 10% return so far this year, vs. a 12.6% loss for the Standard & Poor's 500-stock index. But, warns Marks, "this is not like buying a stock. Once you get in, it's very difficult to get out. You negotiate. You reorganize. The process takes a few years. And no

matter how good you are, you will have some go bad."

More concentrated bets can yield richer rewards. New York's Angelo Gordon & Co. will use \$2.4 billion earmarked for distressed investments to buy up to a third of troubled companies' bond or bank debt to gain clout in allocating assets after they file for bankruptcy. "We try to use the restructuring process to help us get the biggest piece of the pie," says managing director Jeffrey Aronson. The firm then either cashes out or trades the paper to another player looking for a safer bet once the target has emerged from bankruptcy.

Martin Sass of investment firm M.D. Sass prefers to play a grim waiting game. To earn at least four times his investors' money over several years, his \$1.4 billion fund goes in after other investors have completely lost hope that a company will ever be solvent. "We find that deals run into more problems than people expect," he says. "That's the optimal time to buy."

Some bottom-fishers just dig very deep in the trenches for a higher return. David Matlin, who runs a \$2 billion in-house distress fund at Credit Suisse First Boston, aims to quadruple investors' money by buying senior unsecured debt selling for as little as 15¢ to 25¢ on the dollar, according to industry sources. Most investors won't touch such cheap merchandise because the companies are in such poor shape that fixing them takes a lot of work. But, say analysts, instead of loading up a company with more debt—as many vultures did in the early 1990s—Matlin takes control by swapping the debt for equity, hoping to buy companies for three to five times their cash flow, then sell them to corporate buyers for five to six times that.

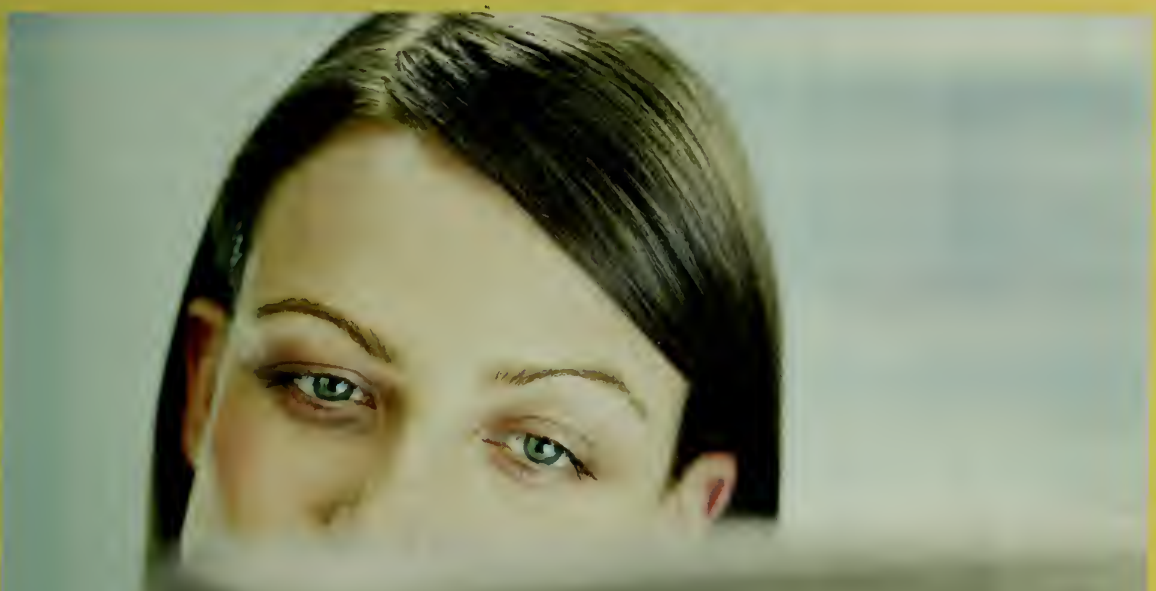
THE LAST-HOPE VULTURES

Mutual funds and investment banks that bought bonds appear to be finding they need to behave like predators to recoup



4 THE HIRED GUNS

Advisers to traumatized execs, such as Terry Savage and Barry Ridings of Lazard Frères and Bettina Whyte of Jay Alix, are in huge demand



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some of their investments. Consider the Scudder High Yield Fund that bought junk bonds issued by Chicago's Metal Management Inc. in 1998. The scrap-metal recycler's chief executive, Albert A. Cozzi, raised \$180 million to snap up six rivals and build his family business. Less than a year later, the formerly Nasdaq-listed company with \$1 billion in revenues went bust after it failed to pay \$18 million in interest on the bonds. Now, Scudder and other creditors are Cozzi's bosses.

On July 1, Cozzi had to hand 99% of his company's equity to bondholders to extin-

guish \$484 million in debt. His creditors left Cozzi in charge. "We were instrumental in the restructuring, but in no way, shape, or form are we running this company," insists a Scudder spokeswoman. Burned bondholders have, however, appointed four of the five board members, one of whom is creditors' adviser Daniel W. Dienst, a managing director at CIBC World Markets Corp. "It's a bitter pill to swallow," says Cozzi.

Other players are trying to step into failing companies much earlier to force them to conserve dwindling cash reserves by halting unrealistic expansion plans. Usually, bondholders can't intervene until a company declares bankruptcy. Investment firm Fir Tree Partners has asked the New York State Supreme Court to declare Internet services provider MPower Holding Corp. insolvent. It wants the court to rule that MPower owes a greater duty to its creditor than to its shareholders, even though the company is not bankrupt. MPower countersued on Aug. 9, seeking \$100 million in

damages from what it believes is a "frivolous and abusive lawsuit. All the same, says Michael J. Petrick, co-head of Morgan Stanley Dean Witter & Co.'s high-yield group, "the onus is on companies to prove to creditors that they have viable business plans."

Bondholders have started to force companies into pre-negotiated bankruptcies. Covad Communications Group Inc., provider of digital-subscriber lines, filed for protection under Chapter 11 on Aug. 15 to get bondholders off its back. Covad offered them \$284 million in cash at 19.2¢ on the dollar and \$100 million in preferred stock in exchange for canceling its \$1.4 billion debt load. "They have to restructure now," says David Rosner of Kasowitz, Benson, Torres & Friedman LLC, who represents Covad's bondholders.

THE HIRED GUNS

Convincing companies to restructure is difficult. Usually, workout specialists are hauled in by lawyers only after things really turn ugly. "I'm the guy elected to tell a CEO, 'You have more problems than you think,'" says Terry Savage, co-head of Lazard Frères & Co.'s restructuring group. He is one of the throngs of Hired Guns who usher traumatized executives through a labyrinthine emergency room that extracts toll at every step of a company's demise—and then its sale or recovery. Corporate loan sharks deliver last gasps of financing. Traders earn fees gambling billions of dollars on the chance of companies' surviving.

Then, restructuring advisers cut deals to satisfy both investors who bought claims at a discount and bondholders and lenders who earlier paid full dollar. That's getting trick-

Cover Story

THE VULTURE HALL OF FAME

1990s



CARL ICAHN becomes key player in bankruptcy reorganizations, including Texaco, Southland, and Trump Taj Mahal. Gets burned badly in first attempt to take control of TWA in the 1980s.

LEON BLACK, ex-Drexel Burnham Lambert banker known as "Dr. No," builds big private buyout firm Apollo Advisors by taking stakes in troubled companies including luggage maker Samsonite.

1980s



SAM ZELL, a.k.a. the Grave Dancer, builds a huge real estate empire by buying bankrupt real estate investments, trusts, industrial companies, shopping malls, office buildings.

MICHAEL PRICE, head of Heine Securities, which managed the Mutual Series Fund, becomes a major player in the reorganization of data-storage maker Storage Technology, Columbia Gas, Zenith Labs, and Sunbeam.

1940s to 1970s

SALIM "CY" L. LEWIS becomes a legendary Bear Stearns trader—and later chairman—by investing in bankrupt railroads and distressed utilities.

GUSTAVE LEVY, chairman of Goldman Sachs, shops bonds of troubled utilities and railroads, culminating in the pivotal 1970s reorganization of bankrupt Penn Central.

1930s



PATRICK MCGINNIS, president of investment firm McGinnis & Co., buys bankrupt railroads, including Boston & Maine Railroad, where he would later become president.

MAX HEINE, founder of Heine Securities, buys up bankrupt railroads like Missouri Pacific Railroad and their real estate. He continues to acquire railroads, including Penn Central, into the 1970s.

1890s

J. PIERPONT MORGAN, head of the Morgan banking empire, reorganizes a slew of bankrupt railroads at the urging of British investors, gaining control of a transportation empire.

Data: Hilary Rosenberg, Edward J. Balleisen, Duke University, *BusinessWeek*



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ier as more traders pile into distressed debt. "I may see a whole new set of faces every time I go to a bank meeting," says Bettina M. Whyte, a crisis manager at Jay Alix & Associates Inc. "Unless the deal has been inked, I have to start over again." And the longer it takes to reach an agreement, the more a bankrupt company's value deteriorates. "It's like Chinese water torture," adds CIBC's Dienst. Nevertheless, more advisers than ever are angling for the lucrative work (box).

However costly the process might be, companies avoid it at their peril. In the past, executives worried about vultures

hovering. Now, if they're in an industry suffering from overcapacity and bloated asset prices, they should worry if vultures aren't in sight. Like it or not, the arrival of the vultures can be a sign that a sector is nearing bottom. Besides, the economy won't resume rapid growth until deadwood has been cut out, making it possible for companies to start investing again in assets that are priced to earn healthy profits.

By Emily Thornton in New York, with Christopher Palmeri in Los Angeles and Mara Der Hovanesian and Susann Rutledge in New York

WHO CAN AFFORD TO GO BROKE?

Not every company that goes into bankruptcy becomes the property of a vulture. But even those that escape face steep bills, thanks to the spiraling cost of going broke.

Consider what's happening to Pa-

Cover Story

cific Gas & Electric Corp. Since seeking protection from creditors in April, it has been billed more than \$7 million in fees from lawyers, investment bankers, and accountants, according to court filings. The company's lead counsel, Howard, Rice, Nemerovski, Canady, Falk & Rabkin, has charged \$2.6 million. Its investment banker, Rothschild Inc., wants \$350,000 a month and a \$20 million success fee. PG&E will also have to pay PricewaterhouseCoopers, financial adviser to its creditors, which has proposed \$900,000 in fees for two months work. Industry sources figure PG&E's final tab could total \$98 million.

AN EDGE. On average, a bankrupt company with \$1 billion in assets pays advisers as much as \$60 million to help strike a deal with creditors (table). One of the highest fees to a single adviser is the \$21.5 million earned by Dresdner Kleinwort Wasserstein for saving bankrupt satellite company ICO Global Communications from liquidation. DKW asked for \$45 million for raising \$1.2 billion in equity in less than a month. But that could soon be surpassed. Some banking sources estimate UBS Warburg could

pull in as much as \$100 million for services to bankrupt wireless startup NextWave Telecom Inc. That would be just shy of Wall Street's largest disclosed mergers-and-acquisitions fee in 2000: the \$102 million split between Bear Stearns, Goldman Sachs, Merrill Lynch, and Lazard Frères for selling Warner-Lambert to Pfizer. UBS Warburg declined comment.

Of course, good advice can be worth the money. Fiber-optic service provider 360networks filed for bank-

ruptcy protection in June, encouraged to do so early by their restructuring adviser Lazard Frères & Co. and law firm Wilkie Farr. By acting fast, they may have gained an edge over competitors. "Level 3 will have about \$750 million a year in interest payments, whereas we are likely to have less than \$50 million. That should be a big advantage for us," says CEO Gregory B. Maffei.

The cost of advice on corporate survival has soared so high that the

**GOING
BANKRUPT
COULD
WIND UP
COSTING
PG&E
\$98 MILLION**

Office of the U.S. Trustee, which reviews fees charged in reorganization plans, is filing objections in bankruptcy courts to the size of the fees that turnaround artists are charging—such as in the case of bankrupt steelmaker LTV Corp.

It's unclear if such efforts will reduce fees yet. But worries about the high cost of bankruptcy have kept some companies out of Chapter 11. Recently, creditors have been cutting deals with companies called "distressed exchanges," in which bondholders forgive a company's debt in return for cash, new bonds, and common stock. "This saves the time and expense of bankruptcy," says Don Morgan, head of the high-yield group at money-management firm MacKay Shields LLC.

But until such deals become the rule, companies better expect to pay big bucks—even if they're in financial distress.

By Emily Thornton in New York, with Christopher Palmeri in Los Angeles



THE HIGH COST OF CHAPTER 11

ADVISER	DEBTOR	CREDITOR
LAWYER	\$500,000- \$1 million per month	\$300,000- \$700,000 per month
ACCOUNTANT	\$200,000 per month	
INVESTMENT BANKER	\$200,000- \$250,000 per month	\$175,000- \$225,000 per month
	\$7 million- \$10 million final success fee	\$3 million- \$8 million final success fee
TOTAL BILL FOR \$1 BILLION DISTRESSED COMPANY RESTRUCTURED IN 18 MONTHS		\$23.2 million - \$60.75 million

WINNING WITH

DIVERSITY

HOW TO RELATE TO THE
NEW BUSINESS MODELS

BY DR. VANESSA J. WEAVER

WHAT THESE CEOs
AND THEIR COMPANIES KNOW ABOUT DIVERSITY

HERE IS A SIMPLE DIVERSITY AXIOM: CEOs THAT "EMBRACE DIVERSITY" HAVE ORGANIZATIONS THAT "LEVERAGE DIVERSITY." THE CEO'S DIVERSITY BELIEF SYSTEM IS SIGNIFICANT IN SHAPING HOW DIVERSITY IS POSITIONED TO IMPACT THE BUSINESS AND ITS SUSTAINABILITY. SEVEN KEY ROLES FOR CEOs AS DIVERSITY CHAMPIONS ARE:

- > To establish and drive a shared diversity vision
- > To articulate a diversity value proposition
- > To serve as the corporate conscience and standard bearer
- > To model appropriate behaviors, or "walk the talk"
- > To plan for and manage diversity resistors
- > To facilitate resource allocation (time, money, people)
- > To require and insure accountability

The diversity debate has shifted from the moral obligation of affirmative action to a business imperative. CEOs, faced with intense competition in global markets, record numbers of mergers and acquisitions, and the global war for talent, are focusing on how to leverage diversity as their competitive differentiator. Recent data equips CEOs with strong evidence that diversity drives business value. *American Management's* recent study, "Senior Leader Teams," which examined over 1,000 companies, demonstrated that companies with multicultural and female members on their senior teams had 21% and 23% (respectively) incremental sales growth, versus 13% for teams with only white males.

The challenge for many CEOs is to directly infuse their diversity belief systems into the organization. The test for diversity practitioners in many organizations is to

overcome diversity resistors and to leverage the power of the CEO's vision to make diversity happen. This special advertising section examines five CEOs' diversity belief systems, and explores how these belief systems drive tangible business results. Featured are IBM, Verizon, Levi Strauss & Co., Duke Energy, and Marathon Ashland Petroleum (MAP). Case studies from MAP, McGraw-Hill, Verizon and Duke illustrate how their CEOs' diversity vision was translated organizationally.

IBM**CHIEF EXECUTIVE OFFICER:** Lou Gerstner**TENURE AS CEO:** seven years

With only seven years at the helm, Lou Gerstner has continued IBM's century-long diversity heritage. It is a heritage based on the philosophy that diversity is the "bridge between the workplace and the marketplace," and is central to IBM's ability to win in the global marketplace. Diversity permeates every facet of IBM's management and technical operations. For example, 57% of IBM's Board of Directors are women, multicultural, and/or non-U.S. born. Under Gerstner's leadership, 40% of IBM's top 54-member Worldwide Executive Council are women, multicultural, or non-U.S. born. These women and multicultural executives have significant revenue responsibility. Gerstner requires his senior management team to be active and visible. Thirty members of IBM's Worldwide Executive Council are involved in guiding specific corporate-wide diversity initiatives. They are held accountable for recruitment, retention and advancement of all talent and, most important, linking IBM's diversity initiatives to the global marketplace.

VERIZON

CO-CHIEF EXECUTIVE OFFICER: Ivan Seidenberg

TENURE AS CO-CEO: less than one year



Since last year's merger of Bell Atlantic and GTE, Verizon is the largest telecommunications company in the United States, serving 128 million access line equivalents and 28 million wireless customers. Verizon is also the nation's 11th largest employer. For this company that touches millions of people, Ivan views diversity as a strategic business imper-

ative. He believes a multi-faceted approach to diversity drives Verizon's success and ability to compete. This strategy includes: acknowledging the unique needs of multicultural employees, customers and other stakeholders; driving value for the customer; enhancing economic development for many types of businesses and communities; increasing shareholder equity; and winning in a global marketplace. Ivan states, "I have to be accountable for making diversity happen just like every employee in the business." To encourage the company's managers to share accountability, Ivan and Chuck Lee (co-CEO) require each business unit to develop and implement a diversity plan and mentoring program. They also have instituted a management bonus and compensation plan tied to diversity performance.

LEVI STRAUSS & CO.

CHIEF EXECUTIVE OFFICER: Philip Marineau

TENURE AS CEO: two years

For Phil Marineau, diversity is a personal core value. "It's an expression of what I and Levi Strauss & Co. stand for. It's right for business, our communities, and for our families. It creates greater tolerance." Phil's diversity belief system translates into a four-component diversity strategy that has been instrumental in building their business:



- > **Sourcing diverse talent**
- > **"Empathetic marketing:" "If you are who you serve, [then] you will be a better marketer."**
- > **Creativity and innovation**
- > **Community involvement**

Phil practices accountability with a "zero-tolerance standard for any forms of discrimination." He models accountability by staying personally involved and talking with small groups about issues of diversity. He also monitors his direct reports' results regarding recruitment, retention, and advancement of diverse people, plus the business results of "empathetic marketing."

DUKE ENERGY

CHAIRMAN, CHIEF EXECUTIVE OFFICER: Rick Priory

TENURE AS CEO: four years



Rick Priory leads a company that successfully uses an enterprise-wide diversity model to support its position as the world's leading integrated energy company. Priory believes that Duke Energy's portfolio of unique businesses must reflect the environments in which their businesses operate. His diversity vision for Duke Energy is to "create and

establish sustainability, with clear and consistent accountability." To hold to this vision, Priory leads by example, sharing accountability for talent development and diversity throughout the organization. Priory provides the presidents of Duke Energy's various businesses with an enterprise-wide framework for diversity, but also grants them the freedom to create their own diversity models to support their business and drive results. Their businesses' commitment and role in shaping goals underscores the fact that diversity at Duke Energy is a top priority—the value and advancement of diversity is embraced by the entire team at Duke.

MARATHON ASHLAND PETROLEUM LLC (MAP)

CURRENT PRESIDENT: Gary Heminger

TENURE AS PRESIDENT: less than one year

Marathon Ashland Petroleum (MAP) has insured continuity in their diversity strategy with the recent promotion of Gary Heminger as President.

This continuity is the result of shared values between Heminger and former President of MAP, John Surma. Heminger's management experiences with both Marathon Oil Company and MAP have demonstrated the importance of diversity to an organization's success. "I consider it a personal challenge that MAP become a premier employer, which means we will attract, promote, and retain a diverse employee body." Further, Heminger emphasizes management's role, stating, "Leadership, direction, commitment, and support from management has to be absolute and unequivocal; not just occasionally—but all the time."



Heminger's ongoing commitment to diversity is exemplified in the continuation of his Diversity Initiative with Tiffin University. The program developed multicultural students' technical and organizational skills through internships and mentoring opportunities at MAP. Heminger believes strongly in the benefits of early mentoring to develop employees.

Dr. Vanessa Weaver, President of Alignment Strategies, has focused on organizational transformation and diversity issues for the past 25 years. She is currently a contributing editor for *US Black Engineer and Information Technology* and *Mosaics*.

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The Presidents of each of these affiliated companies, Gary Heminger (MAP) and Clarence Cazalot (MOC), have committed resources (time, money and people) to insure that diversity drives business success. The head of each diversity organization partners with the respective senior leadership diversity team and meets frequently to search and reapply diversity best practices, identify natural synergies between the two companies and troubleshoot common challenges.

During the last two years, both companies have committed to an inclusive diversity strategy and many corporate-wide diversity initiatives including: 1) customized diversity business case for their respective business; 2) diversity training for over 10,000 employees; 3) a mentoring program; and 4) multi-cultural recruiting. Each company tailored these four initiatives to address their business needs and the unique culture of their organization.

An example of the company's approach to diversity can be seen through a closer look at its refining and retailing business. Marathon Ashland Petroleum's successful implementation of several diversity initiatives demonstrates how focused leadership commitment, a diversity strategy that complements business objectives and a practical plan creates significant results in a short period of time. In fact, diversity is one of MAP's five core values, which are diversity, ethics, environmental stewardship, safety, and premier employer, for which its senior leadership and employees are held accountable.

MINORITY RECRUITING

Faye Gerard's (MAP's Diversity Manager) positive professional experiences as an African-American female chemical engineer, intensifies her commitment to achieve MAP's goal to increase representation of minorities and women in technical positions. The declining number of minorities, particularly minority women, and the increased competition for technical talent makes this a daunting task. MAP's senior executives, partnering with Faye, have created a six component recruiting strategy that focuses on: 1) corporate-wide, cross-functional recruiting; 2) relationship-based recruiting with 1st and 2nd tiered schools; 3) internships; 4) scholarships; 5) informal mentoring; and 6) organizational affiliations.

DIVERSITY AWARENESS TRAINING

The senior leadership felt it was important for each employee to understand diversity's relationship to MAP's business strategies, corporate success and expectations for their behavior. Therefore, MAP required its 6,000 employees to attend diversity training. Managers and supervisors attended an eight-hour in-class session, non-management spent four hours at in-class training and the hourly workforce had computer-based diversity training. In less than 1.5 years, 95% of MAP's workforce has been trained.

MENTORING

Over the last year, MAP has implemented Knowledge Enhancement Exchange Program, (KEEP), a mentoring program that targets all employees. Its objective is to increase retention and contributions to the business, expand individual knowledge bases and further instill MAP's five core values by driving supportive work relationships. There are two target populations: new hires and experienced employees. New hires are paired with experienced MAP employees and experienced employees are paired with senior, more experienced employees. Informal and formal feedback (employee surveys) have indicated that KEEP has been extremely effective.

PHASE II DIVERSITY AT MAP

MAP is now in the design and implementation of its Phase II diversity initiative. This Phase focuses on: 1) increasing diversity skill sets and tools for managers and supervisors; 2) work-life balance; 3) accelerated join-up for new hires; and 4) on-going senior executive leadership for diversity.

IN PURSUIT OF EXCELLENCE

McGraw-Hill's Diversity Program is a Source of Power

DIVERSITY IS A KEY COMPONENT OF THE MCGRAW-HILL COMPANIES' GROWTH STRATEGY. THE MCGRAW-HILL COMPANIES NEEDS EMPLOYEES WHO REFLECT THE INCREASINGLY DIVERSE CULTURES REPRESENTED IN THE CORPORATION'S MARKETS AND CUSTOMERS. DIVERSITY IS ESSENTIAL TO PROVIDE THE TALENT NECESSARY TO SERVE CUSTOMERS' NEEDS AND IS, THEREFORE, AN IMPORTANT INGREDIENT THAT DRIVES SUCCESS.

Diverse, strong talent will power the continuing strength of the The McGraw-Hill Companies' leading financial services, education and business information segments and the Corporation's brands: Standard & Poor's, McGraw-Hill Education and BusinessWeek. It is a leading information company committed to building a corporate culture that fosters teamwork and provides an environment that values, empowers and respects its employees.

The McGraw-Hill Companies emphasizes diverse talent management. One example of its talent management strategy is the Associate Development Program (ADP). Since the program began in 1993, it has attracted talented individuals from top MBA business schools who are diverse in race, ethnicity, experience and perspective. The McGraw-Hill Companies has recruited, developed and promoted many outstanding new managers from the ADP program. They hold leadership positions and significantly contribute to the bottom-line.

The McGraw-Hill Companies also leverages talent in global markets. The Corporation has driven corporate growth in Latin America through Standard & Poor's Credit Market Services and McGraw-Hill Interamericana. These operations are among the Corporation's largest revenue producers in Latin America, with the largest market share among competitors. Local talent has enabled The McGraw-Hill Companies to solidify its brand reputation and market share in Latin America due to their teamwork, experience and knowledge of the needs of the local market.

Attracting, retaining, and developing the best talent for the company will continue to be an area of focus in the near term and the long term. The McGraw-Hill Companies' talent management strategy includes building a talent pipeline by enhancing recruitment efforts in the Hispanic, African American and Asian communities.

Marathon Ashland Petroleum LLC



When he served less than a year as president of Marathon Ashland Petroleum LLC (MAP), John Surma is no novice when it comes to a company's culture to meet its goal of becoming an employer of choice. His senior level experiences with both Marathon Oil Company and PricewaterhouseCoopers have been invaluable as he and his leadership team implement a "Five-Value" proposition which is factored into all facets of business and human asset strategies. The values include diversity, being a good employer, environmental stewardship, and ethics. John believes diversity is a key to MAP's premier status in the market-

place and its ability to attract, retain and promote the most talented employees.

John's belief system, developed early in his career, is driven by a fundamental respect for multicultural colleagues. He readily points to business results that support these beliefs. Among them are MAP's achievements in marketing to diverse customers and creating a work environment that facilitates innovation. He also cited several business benefits of having employees who represent MAP's diverse customers.

Beginning September 1, 2001, Gary Heminger has been appointed president of Marathon

Ashland Petroleum LLC replacing John who has moved on to USX Corporation. Gary's belief systems are as resolute as John's in the role he must play. He states "leadership, direction, commitment, and support from me has to be absolute and unequivocal; not just occasionally - but all the time." As a result, Gary's leadership reflects several best practices including ensuring allocation of resources for diversity (time, money, people).

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John Surma



Gary Heminger

EMBRACING THE FUTURE: VERIZON ADDRESSES ITS HISPANIC MARKET OPPORTUNITIES

BY SHAWN COKER
AND DR. VANESSA J. WEAVER

AS ONE OF THE WORLD'S LEADERS IN THE TELECOMMUNICATIONS INDUSTRY, VERIZON HAS CONSISTENTLY BEEN RECOGNIZED AS A "BEST-IN-CLASS" COMPANY FROM A DIVERSITY MANAGEMENT PERSPECTIVE. VERIZON, FORMED BY THE MERGER OF BELL ATLANTIC AND GTE, HAS ESTABLISHED ITS DOMESTIC AND INTERNATIONAL HISPANIC CONSUMER POPULATIONS AS CRITICAL GROWTH MARKET SEGMENTS.



Verizon understands that to experience sustainable growth in its Hispanic markets, it must also develop business solutions to address its current and future workforce requirements. Oscar Gomez, Vice President of the Office of Diversity and Business Compliance, states, "Hispanic purchasing power is over \$2 trillion and increasing every day. The future of Hispanics equals the future of Verizon." Under his direction, Verizon has recently engaged in business strategies to enhance the development and retention of its Hispanic employee base.

HISPANIC LEADERSHIP AND TALENT DEVELOPMENT

"How can we demonstrate our commitment to Hispanic development at Verizon?" This was a critical question facing Verizon's leadership one year ago, when the company was newly formed. The answer was a corporate-wide process called the Development and Leadership Initiative (DLI). Initially applied to the Hispanic workforce at Verizon, the primary objective of DLI is to drive business results through the increased individual contributions of its employees.

Overseeing this initiative is the recently formed MultiCultural Institute for Excellence (MCIE), the primary role of which is to measure the career development of multicultural talent across the organization. The objective of MCIE is to transfer the successful practices that emerge from diversity initiatives such as DLI throughout Verizon.

HISPANIC SUPPORT ORGANIZATION

As part of the Corporation's commitment to diversity, Verizon sponsors 13 Employee Resource Groups formed by employees who have common interests and concerns. These organizations promote their members' personal and professional growth and provide Verizon with an increased understanding of its multi-

cultural workforce and changing customer base. One such group, the Hispanic Support Organization (HSO), consists of 18,000 employees across the United States. Oscar Gomez explains, "HSO represents a segment of the population that is rapidly becoming the largest in the country. The Hispanic community is important to Verizon, since over 32 million Hispanics live in our franchise territory, with over 70% residing in California, Texas, Florida, and New York."

MULTILINGUAL CALL CENTERS

In fact, HSO was a catalyst in forming Verizon's first Spanish language call center for residential customers, Verizon now has multilingual call centers, responsible for responding to all incoming non-English-speaking or English As A Second Language

(ESL)-speaking customer service and technical support calls.

Ana Garcia-Piedra, Director of Multilingual Sales and Solutions, has one of the industry's most progressive call centers for non-English-speaking or ESL-speaking customers. Verizon's Multilingual Call Centers address over 310,000 calls per month. "Our customer satisfaction ratings are over 95% satisfactory, and we are still improving," says Ms. Garcia-Piedra. Through the multilingual call centers, "We've not only assembled employees who speak 'the language', but we've been able to leverage their cultural connections to the respective communities where they reside," states Oscar Gomez.

SUPPLIER DIVERSITY

Verizon also reaches out to its communities through its Supplier Diversity program. Over the past five years, Verizon has spent more than \$5 billion with business enterprises owned by minorities, women, Vietnam-era veterans and persons of disability. This is a critical element of Verizon's Purchasing philosophy. According to Jeanne Diefenderfer, the senior vice president who led this successful supplier diversity program, "Verizon strives to achieve supplier development by tapping into the resources inherently provided through partnering with minority and women entrepreneurs." In efforts to build highly competitive minority-owned companies, Verizon has established programs requiring their larger suppliers to expand their direct business purchases with firms owned by minorities, women, Vietnam-era veterans and persons of disability. Verizon's business strategies demonstrate that diversity is a top priority for the company. Verizon's co-CEOs, Ivan Seidenberg and Chuck Lee, share this commitment. Oscar Gomez asserts that the belief among top leaders is, "As employees succeed, Verizon succeeds."



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we generate what's next™

BY DR. VANESSA J. WEAVER

GOING GLOBAL, YET REMAINING LOCAL:

DUKE ENERGY'S ENTERPRISE-WIDE DIVERSITY STRATEGY

DUKE ENERGY, ONE OF THE WORLD'S LEADING INTEGRATED ENERGY COMPANIES, HAS GROWN RAPIDLY (\$50 BILLION IN REVENUE) AND GLOBALLY OVER THE PAST FEW YEARS, WITH MAJOR OPERATIONS IN NORTH AMERICA, LATIN AMERICA, EUROPE AND ASIA-PACIFIC. AS THE COMPANY CONTINUES TO EXPAND GLOBALLY, IT RECOGNIZES THE NEED TO TAP THE FULL POTENTIAL OF ITS ENTIRE WORKFORCE AND TO ATTRACT, RETAIN AND GROW DIVERSE TALENT GLOBALLY. DUKE ENERGY'S CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, RICK PRIORY, EXPECTS "SUSTAINABLE DIVERSITY RESULTS AND ACCOUNTABILITY" THAT "BUILDS ON DUKE ENERGY'S TRADITION OF INTEGRITY, ETHICAL STANDARDS, AND RESULTS ORIENTATION." AS A RESULT, THE COMPANY APPOINTED JACQUELYN GATES, VICE PRESIDENT OF DIVERSITY AND ETHICS, TO PARTNER WITH BUSINESS UNIT EXECUTIVES AND EMPLOYEES TO DELIVER SUSTAINABLE DIVERSITY RESULTS FOR DUKE'S PORTFOLIO OF BUSINESSES.

ENTERPRISE-WIDE DIVERSITY STRATEGY

An "enterprise-wide" strategy is new for Duke—but diversity is not. For example, Duke Power, the company's electric franchise in North and South Carolina, had already initiated diversity efforts driven by its multicultural customer and employee base. The challenge for Duke is to go global (company-wide), yet remain local. This task is common to many companies working to infuse corporate diversity initiatives into business units that have historically functioned independently, serving distinctly different markets. These companies often resist "corporate intrusion." In addition, within the same company, many departments may be at different points on the Diversity Continuum. "One size fits all" diversity initiatives aren't well-received and do not always work. Duke's goal is for each business to create its own diversity business case that is relevant to achieving business objectives, while still complying with corporate standards and accountabilities.

Ruth Shaw, executive vice president of Duke Energy's Corporate Resources, demands that their diversity business case focuses first on leveraging internal workplace diversity and identifying opportunities to support internal business partners. In deploying the eight-component enterprise-wide model, Gates' organization positioned its role as partner, rather than diversity police. "One of our core objectives is to increase diversity competencies of employees through cross-functional, self-directed employee teams," states Gates. "This increases innovation, customer satisfaction, market share and profitability."

MOVING DIVERSITY FORWARD

The test at Duke is how each business utilizes the enterprise-wide model. Harvey Padewer, president of Duke's Energy Services group, the growth engine of Duke, mandates that diversity business cases support Energy Services' operating principles of financial performance, growth, business integration and brand advancement. He recognizes that as Energy Services delivers energy and



related infrastructures to the world, the company must blend the talents and perspectives of an increasingly diverse team serving customers and communities around the globe. As chair of the Enterprise Procurement Council, Padewer also champions the corporation's economic development commitment, which includes a Supplier Diversity component. For Duke Energy, creating win-win opportunities by leveraging diversity is critical to substantial business results.



STRATEGIES

SARA LEE: CHANGING THE RECIPE—AGAIN

McMillan expects results in '03, but will investors wait?

Years ago, when a young and brash C. Steven McMillan wanted to get the attention of an auditorium full of door-to-door vacuum-cleaner salesmen, he brought out a 500-pound Persian tiger. McMillan and his feline partner would wrestle, and then the cat would open her jaw, bite his arm, and push him toward her. For the finale, he would stick his head in the cat's mouth. "If I am willing to stand up and do something they thought was crazy, then they were walking up and down the street knocking on doors wasn't such a frightening prospect after all," says McMillan, now the president and chief executive of the company, Sara Lee Corp. McMillan is going to need that kind of boldness as he starts his second year at the helm and the second year of his ambitious overhaul of the Chicago-based

conglomerate. Sara Lee, which sells everything from Wonderbras and Kiwi shoe polish to Endust furniture polish and Chock full o' Nuts coffee, is plagued by stagnant revenues and earnings and a stock price that has fallen by nearly 30% since 1998, to a recent \$22.50 a share. Over that three-year period, sales rose an anemic 1.7%, to \$17.7 billion, for the year ended June 30, while operating earnings rose 5.6%, to \$1.2 billion.

McMillan's answer: While his prede-

OPTIMIST: "We are substantially undervalued," says CEO McMillan

cessor built Sara Lee into a huge portfolio of disparate brands, McMillan is consolidating, streamlining, and focusing the company on its core categories—food, underwear, and household products. So far, he has sold 15 businesses, equaling over 20% of the company's revenue, and has laid off 13,200 employees, nearly 10% of the workforce. He's also reining in a far-flung, decentralized structure.

McMillan is using the cash from asset sales to snap up brands that enhance Sara Lee's clout in key categories. He's also bulking up marketing, giving the biggest boost to brands that were taken for granted in the past. "I do believe that we are substantially undervalued," says McMillan, "and I do believe the things we're doing will enhance the growth rate of our company."

The strategy sounds exciting—just what Sara Lee needs to kick-start growth. Trouble is, the company has been restructuring for years and has little to show for it. This time, McMillan isn't promising any results until 2003 at the earliest, and many investors doubt he'll ever pull the company out of its rut. Indeed, some believe Sara Lee is headed toward a breakup in the next few years. "You've had continual restructuring over the past four years," notes Kevin R. McCloskey, a portfolio manager at Federated Investors Inc., which owns 3.5 million shares. "People thought they were going to jump-start the growth in this company, but so far, it hasn't materialized."

STORE SHORTCUT. McMillan isn't conceding anything. On Aug. 14, he closed the largest deal in Sara Lee's history, a \$2.8 billion purchase of St. Louis-based breadmaker Earthgrains Co. The deal quadruples Sara Lee's bakery operations, making them the nation's second-largest, and it gives the company a direct-to-store distribution system it can use to launch new products. McMillan is also looking for acquisitions in household products and food-and-beverage niches, such as coffee, that promise higher-than-average growth. The company won't comment on specific targets, but

Sara Lee is considered a potential buyer for Dial Corp., the \$1.7 billion soapmaker that went on the block in August.

In 1997, then-CEO John H. Bryan, who will step down as

Sara Lee For years, retailers have dealt with up to 10 Sara Lee meat companies, which are now being combined into 3

The Corporation

chairman in October, was struggling with the same issues: a product lineup that had become far too diversified, a failure to wring full value out of its most famous brands, and growth that was slowing to a crawl in the company's biggest categories. His idea was to transform Sara Lee into a lean marketing machine and leave much of the manufacturing to others. Bryan sold more than 100 factories, from hog-slaughtering facilities to textile plants, and made up a word for this radical effort: deverticalization. With the Internet becoming all the rage, analysts hailed Bryan's bold plan to create a virtual company. But the moves did nothing for profits or revenues. "Sometimes, the more chairs you move around, the more dust you see behind the chairs," says Prudential Securities Inc. analyst John M. McMillan.

Sara Lee's McMillan calls his plan, more simply, a reshaping. In practice, that has meant selling brands—such as Coach leather goods, which fetched \$967 million last year—that didn't fit with Sara Lee's core businesses. McMillan says the effort should start paying off in the fiscal year ending June 30, 2003. "I am much more concerned about what this company looks like and how it is performing four years from now than I am next quarter," he says.

TOO MUCH PAPER. Sara Lee's largest customers are also driving the effort to compact the company's structure. At one time, Sara Lee had close to 200 different regional brands and other business units; McMillan is cutting that number to about 100. For years, retailers have had to do business with as many as 10 different Sara Lee meat companies. "So if you are an Ahold or a Kroger or a Safeway, you've got to deal with 10 different organizations and multiple invoices," says McMillan. Those companies are being combined into three.

Adding to the pressure to consolidate are national retailers such as Wal-Mart Stores Inc. and the largest supermarket chains. They're less interested in stocking regional brands, such as Sara Lee's Bryan Foods, a leader in the Southeast. "Kroger's, Albertson's—these chains

WHAT McMILLAN IS DOING TO HEAT THINGS UP

Sara Lee's chief executive has had a busy first year in the kitchen:

- Sold 15 businesses, equaling 20% of revenues, including Coach leather goods
- Laid off 13,200 employees, nearly 10% of the workforce
- Moved to streamline businesses by cutting overlapping units and combining some regional brands
- Purchased breadmaker Earthgrains for \$2.8 billion, quadrupling bakery operations
- Pumped more money into marketing key brands

don't want regional brands because they want their stores to be laid out the same no matter where they are," says David Adelman, an analyst at Morgan Stanley Dean Witter & Co. "They want the same brands nationwide."

McMillan is also attacking the problem of duplicated effort on the sales side. At a management meeting earlier this summer, the idea came up to go to Wal-Mart with one team instead of sending in a slew of brand managers for various products—something other

30% increase in advertising. One of the new ads for Hanes stars Michael Jordan in a locker room pulling out a pair of athletic-print boxers and a pair of long red briefs from his gym bag as other players watch. The commercial ended with Jordan saying: "Hey, as long as it's Hanes." Other key brands slated for marketing boosts include the Sara Lee flagship, which accounts for only 3% of sales, and new higher-margin products such as Jimmy Dean snack sausage and Ball Park kosher hot dogs.

THIN WIN. But better ads may not be enough to fix fundamental problems in the apparel business. While the company nurtures new growth stars such as coffee and bite-size versions of its leading snacks and desserts, apparel continues to account for 43% of sales, and growth there is at a standstill. Sara Lee, which owns Hanes and Playtex underwear and Leggos hosiery, has a leading U.S. market share in men's and boys' underwear, 43.1%, but that gives it little more than bragging rights because margins are so thin. McMillan is counting on more spending on brand-building to boost profits. But "the scary thing is, even if you fix that business, it's still apparel, and it's not really viewed as a high-value-added business," says Eric K. Katzman, an analyst at Deutsche Banc Alex. Brown.

Is McMillan the man who will finally ignite growth at Sara Lee? Raised in Alabama and a graduate of Auburn University, he went north to earn an MBA at Harvard University. He has spent 25 years at Sara Lee, running all of its major business lines—including the Electrolux vacuum-cleaner unit that Sara Lee sold about 10 years ago. He also oversaw mergers and acquisitions and served as president before his promotion to CEO, and

Some analysts note Sara Lee's years of restructuring with little to show for it—and predict a breakup

he's in line to succeed Bryan as chairman. Despite his solid track record and bold strategy, at times even McMillan seems uncertain whether his plans will work. "When your stock price is not performing, you sit and agonize and say, 'Well, what do I do next?'"

He may not have much time to reflect. Analysts give him about a year and a half to show results before further divestitures or even a breakup become inevitable. McMillan jokes that if his efforts at Sara Lee fail, he could always fall back on his experience taming tigers and join the circus. Either way, lunch might be someone's lunch.

By Julie Forster in Chicago



Brand-building is another major part of McMillan's strategy. He has boosted spending on marketing by 8% this year, to \$2.3 billion, including a



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WHAT YOU NEED
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BusinessWeek Investor

Don't Turn Your Back On Overseas Stocks

Over time, international diversification still pays off

BY JULIA LICHTBLAU

In the 17th century, French philosopher Blaise Pascal concluded that it was impossible to persuade skeptics to believe in God through reason. Instead, he urged them to bet in favor of faith. They had nothing to lose by believing and everything to gain if it turned out they'd made the right choice, he said.

These days, many U.S. investors must feel like Pascal's nonbelievers when they hear investment advisers say they need a healthy mix of foreign stocks in their portfolios. And—despite the temporal subject—the arguments sound remarkably similar. Essentially, they're asking investors to have faith in a tenet of portfolio theory that hasn't been convincing in recent years: the idea that adding international stocks to a domestic portfolio enhances returns and reduces risk long-term because foreign markets' trends offset those of the U.S.

Certainly, no one could blame U.S. investors for doubting the virtues of sending their money abroad. Over the past decade, the U.S. market has dramatically outperformed the developed foreign-market benchmark, the Morgan Stanley Capital International Europe Australasia and Far East Index (chart). Annualized returns for the Standard & Poor's 500-stock index were 17.47% from 1991-2000, more than doubling the 8.52% earned by an EAFE portfolio. In dollars, the Nikkei fell 2.35% a year on average during that period. Even in 2001, a miserable market year all around, the S&P's 10.68% drop as of Aug. 27 is beating EAFE's 26.59% decline.

The U.S. dollar's strength against the euro (and its predecessors) and other foreign currencies since the mid-'90s has also made foreign stocks a tougher sell. A U.S. investor can lose money on rising British or Japanese stocks if the pound or yen fall against the dollar.

Investment gurus began preaching the international investing gospel in the 1970s, when the U.S. was in an extended bear market. It made sense then. The dollar was weak, and the S&P returned an average of only 8.45% annually, vs. 13.78% for the EAFE during the decade. In the 1980s, the U.S. bull market took hold, but stocks in Japan and Western Europe did even better, especially after the dollar collapsed from its mid-decade peak.

Then came the 1990s. European stocks, bene-

fitting from ongoing economic unification, were relatively strong. But overall results from the EAFE index were depressed by the collapse of Japan's highflying market and the 11-year economic slump in which it's still stuck. Weak foreign currencies eroded U.S. investors' returns even more.

Disappointed with recent results, many investors have forgotten the stellar returns of earlier decades. Many question whether international diversification remains a valid concept. "From the point of view of the U.S. investor, who has tremendous opportunities to diversify at home, international investing has been oversold," says Robert M. Aliber, professor of international economics and finance at the University of Chicago. Even if foreign investments outperform domestic ones, adds, higher fees eat up the extra return.

"PHONY ARGUMENT." Others say you can get the benefits of international diversification without the headaches of foreign stock ownership by investing in U.S. companies that do much of their business abroad. That way, you get exposure to non-U.S. economies but with the protection of U.S. securities regulation, says Roy Papp, whose

Papp America-Abroad Fund does just that. He also dismisses as a "phony argument" the notion that global diversification reduces risk because movements in one market offset those in another. Thanks to globalization, points out, markets increasingly move in tandem.

It's an eternal truth that when investors start doubting or even dismissing an investment strategy, it's about to come back in fashion—and profitability. If nothing else, the dollar, long a drag on foreign returns, is starting to weaken. "That's positive for U.S. investors," says Barton Biggs, global investment strategist for Morgan Stanley. "Instead of having the wind in their face and losing money on overseas investments [from the strong dollar], they'll benefit." Biggs foresees a two- to three-year period of dollar weakness (page 132).

What's more, some global strategists argue that many foreign companies are better built than their U.S. counterparts. Even with the





Just as an investment strategy is being dismissed, it often returns to profitability. In fact, the U.S. dollar is already starting to weaken

S. market down, the past 12 months' price-earnings ratio for the S&P 500 is 33, while Morgan's European 500 Index of the continent's biggest companies by market weight is valued at 22.

Another case for diversifying: The U.S. can't perform forever. So hedge your bets. "Diversification assumes you don't know which country is going to be the best performer for the next 10 years," says Ernie Ankrim, director of portfolio strategy at Russell Investment Group. In other words, "long-term diversification always results in better returns than the worst performer for any market."

Perhaps the best case for globalizing your portfolio is that over the very long term, say, 30 years, there's no opportunity cost vs. having put all your money at home. The 30-year average returns for U.S. and international invest-

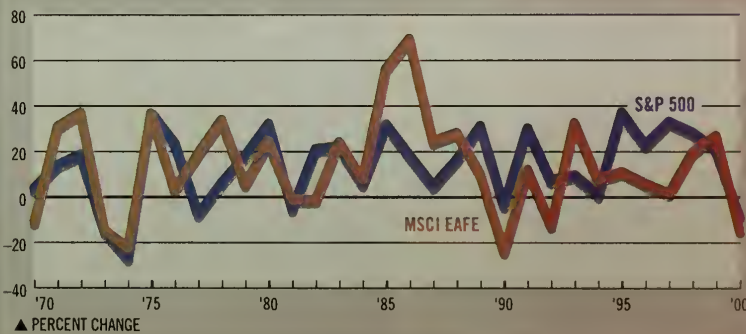
ing are nearly identical—14.12% for the S&P, vs. 14.21% for EAFE.

There was lots of year-to-year volatility under those averages. The S&P ranged from -26.5% to 37.4%, and EAFE veered from -23.2% to 69.9%. But diversification helps lessen risk in your holdings. According to Russell, a portfolio that was two-thirds invested in the S&P 500 and one-third in EAFE had a 30-year average annual return of 14.08%—a hair less than either an all-U.S. or an all-EAFE portfolio. But the blended portfolio was less volatile than either, when measured by the year-to-year fluctuations in value.

Salvation, not international investment diversification, was Pascal's main concern in the 17th century. But if he were alive today and pondering portfolio theory instead of religion, he might well find himself preaching a version of his bet to doubting U.S. investors. ■

The Case for Going Global

Year by year, the U.S. and major non-U.S. stock markets can have wide swings in results. But over the past three decades, the average returns from the Standard & Poor's 500 and the Morgan Stanley Capital International Europe Australasia and Far East Index are nearly identical. An allocation of two-thirds S&P 500 stocks and one-third EAFE delivers nearly the same return with less volatility.



Data: Russell Investment Group

THE RIGHT WAY TO PLAY EMERGING MARKETS

BY PETE ENGARDIO



Poland's stock market is down 30% this year even though the nation has halved its inflation rate, expects respectable economic growth of 3.5%, and boasts Eastern Europe's best-regulated financial system. India has enjoyed 6% annual growth since 1991 yet has seen its main stock index remain at basically the same level it was at then. Until just recently, Taiwan's tech-export-led economy had been barreling along even through the Asia crisis. Yet the country's chief stock index has lost some 60% of its value since 1989.

What's going on? When U.S. mutual funds began to aggressively hawk "emerging markets" in the early 1990s, thousands of companies once owned entirely by families and governments were listing shares, and there was big money to be made by supplying a growing middle class with phones, TVs, and autos. Sure, these nascent market economies would suffer wild ups and downs. But investors were told that they would retire richer for having endured volatility.

That hasn't happened. A nimble market-timer could have done well, but the long-term play has been a bust. Had you bought into Fidelity Emerging Markets Fund a decade ago, your average annual return would have been minus 2.3%. Over the past five years, you'd have lost 14.4% annually. Most similar funds tracked by Morningstar haven't done much better. But if you had stuck with the Standard & Poor's 500-stock index for the past decade, you'd have earned an annualized 14.5% return.

Why the poor performance? By the time U.S. fund firms entered the fray in the early '90s, early birds such as Templeton Emerging Market Funds' Mark Mobius had already made their windfall. True, funds earned an average 75% return in 1993. But that lured more people into emerging markets in time for the correction of 1994. Except for a nice bounce in 1999, emerging-markets funds—including Templeton's—have been losers ever since.

Investors have learned some sobering lessons. Currency gyrations, political upheaval, bureaucratic policy flip-flops, and

the herd mentality of global hot money can influence a small stock market much more than traditional economic fundamentals. A string of financial shocks, beginning with Mexico in 1995 and including Thailand, Russia, Turkey, and Argentina, also have ruined confidence.

The more stinging reality, though, is that many listed companies in these nations aren't run for the benefit of shareholders. Governments, such as Malaysia's and China's, often pressure strong companies to buy or bail out weak ones. And highfliers with thriving core businesses pump capital into excess capacity or real estate boondoggles—or siphon funds into



TAIPEI: The economy was strong, but the stock market wasn't

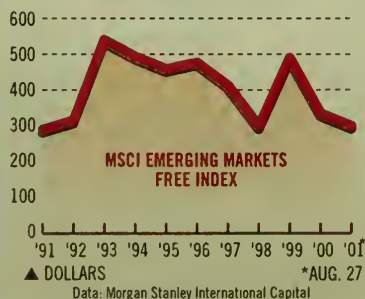
private projects. "People are waking up to the fact that there has been cheating, lying, and bad corporate governance," says Mobius.

That's not to say you should shun a company just because it's in an emerging market. Indeed, some are formidable global players and do return profits to shareholders. Among them are Taiwan Semiconductor Manufacturing, Mexico's Cemex, and South Korea's Samsung Electronics. Sure, they're affected by jitters at home, but much of their revenue is in dollars and foreign institutions hold their shares.

You don't need to buy into an emerging-market fund to own these stocks. As capital markets become more global, funds that invest in sectors such as energy or electronics will include them. Merrill Lynch emerging-market strategist Adrian Faure counsels institutional clients not to invest by country but in good companies wherever they're based. That makes sense for individual investors, too.

Engardio, a former Asia correspondent, writes about global economics.

The Lost Decade



Perreting Out the Best Foreign Small-Caps

ten cheap, they can help you to diversify



LEWIS BRAHAM

To fund manager Jean-Marie Eveillard, OPC Groep is the mouse that roared. Thanks to sharp rallies in tiny, unknown stocks, such as this Dutch pharmaceutical distributor, Eveillard's First Eagle SoGen Overseas Fund has delivered an 8.3% return in the past 12 months, while most foreign equity funds have stumbled. "In continental Europe and Japan, small-caps are much more neglected than in the U.S.," he says. "We see that as strictly an advantage."

Neglected stocks are usually cheap, foreign small-caps exceptionally so. Right now, such stocks have an average price-to-book ratio of only 2.4, less than half that of the Standard & Poor's 500-stock index. These bargains often become the subject of takeovers or leveraged buy-outs; that can give a big boost in returns. Yet most foreign equity funds won't benefit from this trend because they don't buy small-caps: Their median stock has a hefty \$18 billion market capitalization.

Because of their obscurity, foreign small-caps also make better diversifiers than large companies. A measurement known as R^2 determines how well the returns of a stock match, or "correlate," with those of a benchmark index every month. According to fund company Dimensional Fund Advisors, the R^2 of the average foreign small-cap stock was just 0.49, or 49%, correlated to the S&P 500 over the past five years. By contrast, large-cap foreign stocks were 77% corre-

lated. By giving you greater diversification, small-caps should reduce your risk over time.

Since tiny companies trade mainly in local markets and require extensive research, it's best to purchase them through one of the 28 foreign small-cap funds. Oakmark International Small Cap Fund is good for value investors, having delivered a 22.6% annualized return over the past three years. Growth investors may like Schroder International Smaller Companies and cs Warburg Pincus International Small Company funds, though they've suffered in the tech rout.

A fund needn't have "small-cap" in its name to invest in them. Such top performers as Tweedy, Browne Global Value, MFS International New Discovery, and Eveillard's SoGen buy small caps, though they have the leeway to own larger companies. To see if a fund does the same, check its median market capitalization at www.morningstar.com. This stat measures the capitalization of the holdings. If the market cap is below \$1.4 billion, the fund is small-cap.

For value loyalist Eveillard, Japan is bargain heaven. But growth managers, such as Schroder's Matthew Dobbs, aren't always interested in waiting for takeovers. "I want to own great companies in the early stages of their development," he says, "so identifying superior earnings growth is key." Dobbs is betting on British construction stocks Taylor Woodrow and Carillion because the government is raising public works spending.

Both strategies have worked in the past, but right now value stocks seem to be more in favor. Oakmark manager Michael Welsh profited recently when Hong Kong retailer Jusco Stores nearly doubled in two days, thanks to a positive earnings report. "You may sit on dead money until these companies are discovered, but a 90% move in two days makes it all worthwhile," he says. With small-cap investing, waiting for others to discover your stock is half the battle. That patience is usually rewarded.



Funds Stocked with Small Fry

FUND NAME/ MBOL	TOTAL RETURN*		MEDIAN MKT. CAP. MILLIONS	R2**
	YTD	3-YR.		
WARBURG PINCUS INTL. SMALL CO. WINSX	-23.3%	25.3%	\$652	20%
FIRST EAGLE SOGEN OVERSEAS SGOVX	7.1	15.6	822	38
MFS INTL. NEW DISCOVERY MIDAX	-6.8	21.9	2,876	50
OAKMARK INTL. SMALL CAP OAKEX	8.5	22.6	367	38
SCHRODER INTL. SMALLER COS. SSCIX	-15.9	17.8	510	18
TWEEDY, BROWNE GLOBAL VALUE TBGVX	-1.2	14.5	3,593	41

*Appreciation plus reinvestment of dividends and capital gains before taxes. Year-to-date and three-year annualized total returns as of Aug. 27, 2001.
**Three-year correlation with Standard & Poor's 500-stock index

Data: Morningstar



'There Are Great Opportunities in Europe'

A talk with Morgan Stanley's Barton Biggs

BY SUSAN
SCHERREIK

If you are like most investors, you've had a tough time making money in U.S. stocks this year. Investing overseas has been even more disappointing: U.S. equities lost an average of 9.8% this year through Aug. 27, vs. a 16.6% decline for foreign stocks. What should you do?

We posed that question to Barton Biggs, chief global investment strategist at Morgan Stanley. As head of the firm's global asset allocation operations, Biggs oversees \$15 billion in investments. But individual investors can tap his expertise through the \$600 million Morgan Stanley International Fund, which he co-manages with Ann Thivierge. The fund is off 12.6% this year through Aug. 27, a better

"The dollar will ... weaken against the currencies of the world over the next two to three years. That's positive for U.S. investors in foreign markets"

showing than the average 14.3% loss racked up by international funds, according to Morningstar.

Biggs, 67, is bearish on U.S. stocks and sees better opportunities abroad. Personal Finance Editor Susan Scherreik recently spoke with Biggs about his investment views.

What's the point of U.S. investor diversifying overseas?

International markets have underperformed the U.S. for most of the last several

years. But I think that is about to change.

Why?

U.S. stocks are much more expensive, and U.S. corporations have already done all the right things to increase shareholder value, as well as used all the accounting tricks to look good. Foreign corporations still have those things ahead of them. So, coming out of this global bear market, the international markets should do better.

When will the global bear market end?

A worldwide recession is still unfolding. But I guess is that 12 months from now it will be clear that the global economy is recovering. I think we'll see real economic growth around the world at a 3.5% pace a year from now, vs. 2% a year falling today. Stock markets will discount a recovery ahead of time, so equities should be improving late this year or early next year.

How does the U.S. dollar figure in your forecast?

We are coming to the end of the strong dollar era. The dollar will gradually weaken against the other currencies of the world over the next two to three years. That's positive for U.S. investors in foreign markets. Instead of having the wind in their face and losing money on overseas investments because of the strong dollar, they will benefit.

Where can investors find the best foreign investment opportunities?

There are great opportunities in Europe—Germany, Britain, and France, in particular. The European economies are following the American model: They are cutting tax rates, supporting shareholder value programs, and giving corporate managements incentives to perform well and lift their stocks' prices. The adoption of the euro also is going to be a very powerful growth factor in Europe.

What about stock valuations in Europe?



"Japan is incredibly cheap. Japanese stocks sell on average at 70% of corporate sales—vs. 200% in the U.S. and 120% in Europe"



Biggs's Global Picks

CONSUMER PRODUCTS "In a low-inflation, slow-growth world, consumer-products companies that grow in the 4% to 6% range will receive high valuations as defensive equities"

ENERGY "As world energy consumption swells and the world's oil reserves decline, energy companies will benefit from higher oil prices and increased exploration and development"

PHARMACEUTICALS "Drugmakers with strong new-product flows should be able to maintain pricing power and show double-digit earnings growth, which will be a rarity in a tougher environment"

European stocks are considerably cheaper than [those] in the U.S. A rough measure of relative value is stock market capitalization as a percentage of gross domestic product. In the U.S., market capitalization is 151% of GDP, vs. 59% in Europe. That's a huge difference.

What other countries should investors focus on?

China is the fastest-growing major economy in the world, and I think it's going to keep on being that. It may have some indigestion in the short run but it's got huge markets, and the government, for all its communist background, is following a very capitalistic, free-enterprise model. So I think China, and the stock market of China,

which at this point is Hong Kong, going to do very well.

What about the rest of Asia?

Singapore is a high-quality market, especially its banks, which are probably the strongest in Asia. Australia looks very attractive, and I think eventually Japan is going to be attractive.

What do you like about Japan?

With a new Prime Minister in place, there are finally signs of reform. Japan has been through depression comparable with the U.S. in the 1930s. But it has tremendous potential if it can get its act together in the next five years. Also, Japan is incredibly cheap. Japanese stocks sell on average at 70% of corporate sales—vs. 200% in the U.S. and 120% in Europe.

What are the risks involved in investing in these countries?

European and Asian stock markets aren't strong buys right now because they will continue to decline in coming months, along with the U.S. market. Nevertheless, they are going to be attractive. Over the next few years, Asian and European markets could return an average 10% to 11% annually, vs. around 5% in the U.S.

How much of an investor's portfolio should be in foreign stocks?

I recommend that investors have half their overall portfolio in U.S. Treasuries or high-grade tax-exempt bonds and put another 10% in cash. The remaining 40% should be in equities, and half those equities should be outside the U.S., mostly in Europe and Asia. As foreign stocks decline further, you should add to the overseas position by using the cash and selling some of the bonds.

What countries would you avoid?

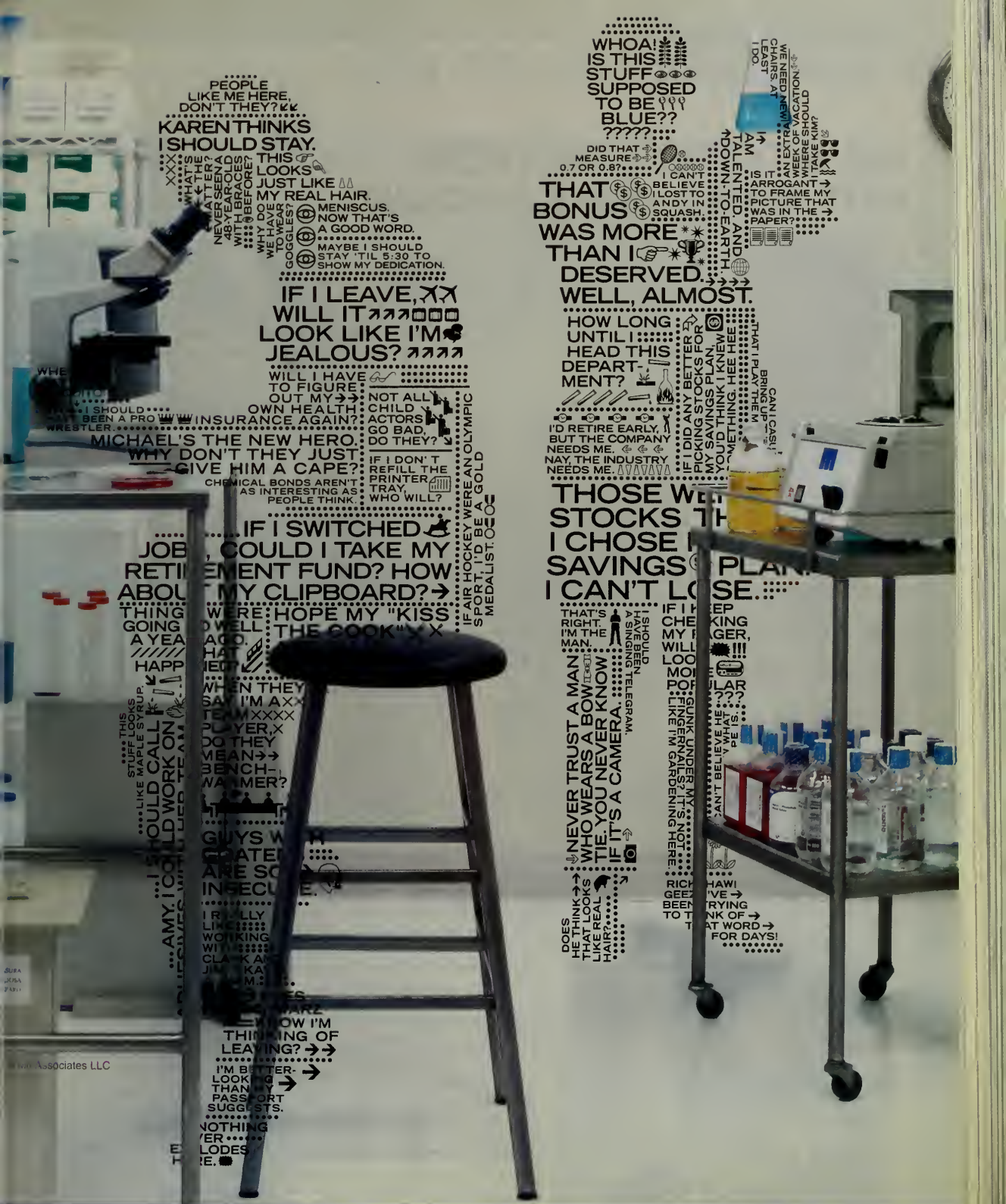
Mexico and Canada, because they are so linked to the U.S.

What about the rest of Latin America?

Brazil is one of my favorite long-term investments. It's a big, fast-growing economy with huge potential. That said, the currency crisis in Argentina will continue to contaminate Brazil in the short run.

Should investors also buy foreign bonds?

High-grade German and French bonds are attractive. They are yielding about 5.5%. Their returns will be enhanced as the euro appreciates against the U.S. dollar.



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GE STOCK: CHEAPER, BUT STILL NO BARGAIN



BY ROBERT BARKER

rb@businessweek.com

A closer look at the combined value of GE's components shows that, despite a drop of one-third in the past 12 months, the stock may be overpriced

Jack Welch's 20 years in the role of General Electric CEO has been a bravura performance in most every way. Welch, who is set to step down on Friday, Sept. 7 after a final board meeting, took GE from No. 8 in the ranks of companies by stock-market value to No. 1. He succeeded in applying his famous "No. 1 or No. 2" dictum to GE's ultimate product, its stock. He did so by "branding" it with the twin hallmarks of financial strength and profit growth, plus an eerie, cyborgian consistency. GE is, in fact, strong, growing, consistent. What GE isn't is cheap.

This is true despite a forgettable past 12 months that have seen GE surrender nearly a third of its market value. From \$60.50 a share last August, GE lately is trading near \$42 (chart). With a market value of \$415 billion, it remains comfortably ahead of No. 2 Microsoft, at \$335 billion. But instead of paying 45 times estimates of the coming year's profit, as they did a year ago, buyers of GE today pay just 26 times.

If you ask me, that's still no bargain. One reason is simply the improbable task faced by Welch's successor, Jeffrey Immelt, in greatly expanding GE's profitability. Welch widened GE's margins to more than 20%, from 9%. That proved to be a mighty lever in delivering consistent annual profit growth near 15%. Common sense suggests such a boost will be harder to come by.

Even if Immelt somehow overcomes those odds, there's no escaping the extravagant premium that remains built into the company's stock-market value. To see what I mean, evaluate GE with me by its eight operating segments (table). I first figured the profit each segment generated in the 12 months ended June 30. Next, to put a reasonable earnings multiple on each segment, I looked at their records of growth in

sales and earnings, at their competitors' market multiples, and at multiples paid in mergers. In each segment, I granted GE the benefit of the doubt and erred on the high side. For example, Whirlpool's market value is \$4.6 billion, six times its operating profit over the past four quarters. Maytag's multiple is a bit below 10. Giving GE Appliances an operating profit multi-

ple of 10, I estimated its worth at \$6.4 billion.

Make no mistake, this is back-of-the-envelope stuff, which became most hazardous with GE's ant financial arm, GE Credit Services. Its eclectic \$376 billion portfolio, from credit-card receivables to real estate loans and insurance contracts, makes GECS a cross between odd duck and golden goose. I settled on 24, a multiple between those enjoyed by slower-growing Citigroup (18 times net profit) and less-leveraged American International Group (30 times). That indicates GECS is worth \$134 billion, or 0.36 times its assets. In a pending deal for Heller Financial, GECS is paying 0.27 times assets. Tyco International in June paid 0.2 times assets for CIT Gro-

HOW IT ALL ADDS UP

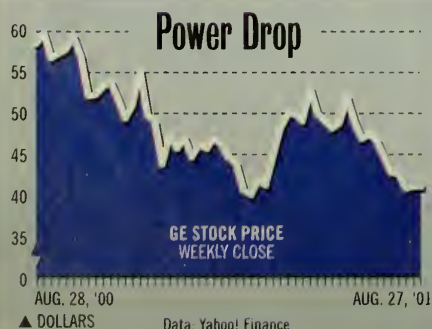
SEGMENT	OP. PROFIT* MILLIONS	PROFIT MULTIPLE	EST. VALU MILLIONS
AIRCRAFT ENGINES	\$2,562	12	\$30,744
APPLIANCES	637	10	6,370
INDUSTRIAL PRODS., SYSTEMS	2,050	10	20,500
GE CAPITAL SERVICES	5,583	24	133,992
NBC	1,655	25	41,375
PLASTICS	1,849	10	18,490
POWER SYSTEMS	3,782	12	45,384
TECHNICAL PRODS., SERVICES	1,888	15	28,320
TOTAL ESTIMATED VALUE	\$325 billion, or \$32.50 a share		
RECENT STOCK MARKET VALUE	\$415 billion, or \$41.50 a share		

*12 months ended June 30; figure for GE Capital is net profit

Data: Company reports, BusinessWeek estimates

Despite granting GE premium multiples, the sum of my estimated values for its eight segments still came only to \$325 billion, or \$32.50 a share. Could that be right? Could the market be so wrong about a company that's so well known on Wall Street? GE thinks so—but in other direction. "The stock is undervalued," \$41, a spokesman told me. "We believe that you have the right parts, the whole will be greater than the sum of the parts."

Yet, if you find yourself tempted by GE, keep in mind just a few more facts. In 1981, the year Jack Welch became CEO, GE's market capitalization was less than \$14 billion. Not until 1991 did it cross the \$100 billion threshold. Then the next five manic years, its value soared to nearly \$600 billion—a sixfold increase even if profits did not quite double. Now, suppose investor enthusiasm were to cool. Suppose the stock were to retreat to its 1995 multiple of 10. It then would sell for \$22 a share.



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FOR STORMY DAYS: IPC



GENE G. MARCIAL

insurer IPC
could weather
turbulent times
scathed. Will
Sprint get a fresh
buyout bid?
Verizon may know.
Drugmakers snap
Compugen's
new techniques

Tired of the turbulent market? Then you might look at IPC Holdings (IPCR): The stock of this property-catastrophe reinsurer has held up nicely through the storm. It rebounded from 18 in mid-April to 23 on Aug. 29. "This is the kind of stock true-blue value investors love," says Scott Black, president of Delphi Management, which steers some \$1.5 billion. IPC is a Warren Buffett type of stock, notes Black: It trades at book value, its price-earnings ratio is a depressed 7, and it beat the Street's second-quarter estimates with earnings of 77¢ a share—better than the consensus 64¢. And with its outlook looking rosier—despite having to make provision for destructive weather, such as Hurricane Allison—IPC has decided to pay a quarterly dividend of 16¢ a share, or a 2.8% yield, starting in September. While second-quarter calamities dampened results at primary insurance carriers, IPC was unscathed, notes Jay Cohen of Merrill Lynch, because of its tightened underwriting discipline.

Delphi's Black argues that IPC, like its peers, deserves a P/E of 10 or 11. With 2002 earnings expected to hit \$2.90 a share, that translates to a stock price of 30 to 33. For 2001, Black sees earnings of \$2.60, up from 2000's \$1.71.

Based in Bermuda, IPC spreads its operations—and risks—around the globe. Formed in 1993 to take advantage of the crunch in reinsurance capacity after Hurricane Andrew, the company went public in 1966 and is 24%-owned by global insurer American International Group, one of the original backers. Another big stakeholder: Fidelity Management, which owns 10%.

SPRINT'S PHONE COULD RING AGAIN

Remember when WorldCom tried to buy Sprint (FON) in March, 2000, only to be nixed by federal regulators? WorldCom would have paid \$76 a share in stock for Sprint, the No. 3 long-distance carrier. Will there be a second-round fight for Sprint? "That's a likely scenario, with the market putting a low value on Sprint," says John Maloney, who runs M&R Capital Management, which is buying into Sprint not for its buyout appeal but as a sum-of-the-parts value play.

WorldCom, which soared to 64 in 1999, now trades at 14, which rules it out as a bidder, says Mal-

oney. Sprint stock, which hit 75 in 1999, has also swooned, to 22, in the telecom slump. But that has made Sprint a tempting target, he argues. Maloney puts the intrinsic worth of Sprint's combined assets at 42 a share. Maloney values its local phone business alone at \$22.5 billion, or 24 a share. Long-distance, with revenues of \$7 billion, is worth 8. And the data and Internet business, with \$3 billion in sales, is worth \$9 billion, or 10 a share. The directory and products unit, worth \$3 billion, should just offset Sprint's long-term debt of \$3 billion, figures Maloney.

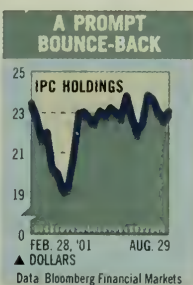
Who might snap up Sprint? Verizon Communications is a likely suitor, says Maloney. Now at 50, Verizon has a market cap of \$137 billion. The No. 1 U.S. provider of wireline and wireless communications, it has 95 million access lines and 25 million wireless customers. With or without a deal, says Maloney, Sprint is an attractive call. Sprint and Verizon didn't comment.

PROMISING LEADS AT COMPUGEN

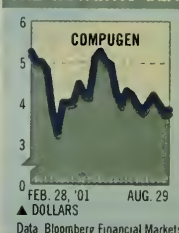
The gene-discovery technology of tiny biotech outfit Compugen (CGEN) has attracted a couple of major drugmakers. Pfizer has been using its so-called LEADS platform for gene discovery since 1998. And on Aug. 2, Switzerland's Novartis said it would use Compugen's LEADS program and DNA chip-design services to expedite its identification of drug targets. Some think Compugen will announce another partnership deal for its products in a few months.

LEADS is designed to help drugmakers extract information from genomic and protein data to accelerate development of biological products. Edward Tenthoff of Robertson Stephens says Compugen provides analysis tools and software to select novel genes and proteins that will make the best drug targets.

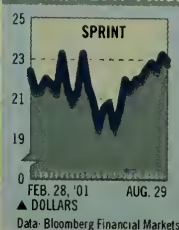
Like most other small biotechs, Compugen has yet to make money. Its stock rose from 3 a share in March to nearly 6 in May in anticipation of the Novartis deal. But it has since eased to 3.95. Even so, some pros think the dip provides another chance to buy in—before it doubles again. Some insiders have been buying, including Chairman Martin Gerstel, who picked up \$3.5 million worth recently, for a total stake of 5.8%. Gerstel, CEO of Alza from 1987 to 1993, is credited with building up Alza, which Johnson & Johnson has bought. Some think Gerstel aims to build Compugen into another Alza.



A SPIKE BEFORE THE NOVARTIS DEAL



A TEMPTING TARGET AT THIS LOW PRICE

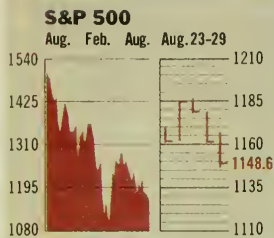


MALONEY: New battle brewing

BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:10 p.m. EST on CNNfn's *The Money Gang*.

Stocks



COMMENTARY

Last week's rally is but a distant dream. The markets fizzled out by mid-week as investors settled back in on reality: Earnings and the economy aren't likely to recover soon. New GDP numbers show the U.S. economy grew at its slowest pace in eight years, while consumer confidence hit a four-month low. Tech giants Advanced Micro Devices, Microsoft, and Oracle faltered.

Data: Bloomberg Financial Markets
Bridge Information Systems, Inc.

U.S. MARKETS

	Aug. 29	Week	Year to date	Last 12 months
S&P 500	1148.6	-1.4	-13.0	-23.9
Dow Jones Industrials	10,090.9	-1.8	-6.5	-10.0
Nasdaq Composite	1843.2	-0.9	-25.4	-54.8
S&P MidCap 400	496.7	-0.4	-3.9	-7.0
S&P SmallCap 600	225.3	-0.5	2.6	2.2
Wilshire 5000	10,644.2	-1.3	-12.6	-24.8

SECTORS

	Aug. 29	Week	Year to date	Last 12 months
BusinessWeek 50*	767.7	-2.0	-20.9	-41.4
BusinessWeek Info Tech 100**	384.1	-1.8	-32.1	-60.4
S&P/BARRA Growth	576.0	-1.5	-16.2	-37.0
S&P/BARRA Value	573.1	-1.4	-9.9	-8.3
S&P Energy	855.6	-0.6	-8.2	-6.4
S&P Financials	146.9	-3.4	-10.8	-4.2
S&P REIT	96.2	-1.6	9.4	15.6
S&P Transportation	673.9	0.4	-3.4	11.2
S&P Utilities	285.1	1.8	-18.7	-6.7
GST Internet	92.5	-5.8	-49.1	-79.8
PSE Technology	643.7	0.1	-21.0	-44.0

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Engineering & Constr.	16.8	105.9
Office Equip. & Supplies	11.9	69.0
Tobacco	9.5	59.5
Metal & Glass Containers	8.4	52.9
HMDs	8.0	51.6

EQUITY FUND CATEGORIES

	4-week total return %	52-week total return %
Leaders		
Precious Metals	5.1	19.7
Real Estate	4.6	15.0
Health	4.2	15.0
Europe	-0.2	11.9
Laggards		
Communications	-10.0	-58.9
Technology	-9.7	-54.5
Mid-cap Growth	-5.5	-41.4
Large-cap Growth	-5.2	-35.3

EQUITY FUNDS

	4-week total return %	52-week total return %
Leaders		
Potomac Internet Short	21.1	206.0
ProFunds UltraShort OTC	17.8	148.3
Rydex Dynamic Vent. 100	17.5	140.3
Matthews Korea	10.5	95.4
Laggards		
Amerindo Technology D	-21.3	-90.5
iShares D.J. U.S. Internet	-19.8	-84.3
ProFunds UltraOTC Inv.	-19.2	-84.3
Berkshire Focus	-19.0	-83.9

Data: Standard & Poor's

GLOBAL MARKETS

	Aug. 29	Week	Year to date
S&P Euro Plus (U.S. Dollar)	1120.5	0.0	-21.4
London (FT-SE 100)	5417.6	-0.2	-12.1
Paris (CAC 40)	4834.9	0.5	-18.4
Frankfurt (DAX)	5305.0	1.6	-17.1
Tokyo (NIKKEI 225)	10,979.8	-3.7	-20.4
Hong Kong (Hang Seng)	11,242.4	0.5	-25.1
Toronto (TSE 300)	7494.4	-0.6	-16.1
Mexico City (IPC)	6324.9	-0.1	11.1

FUNDAMENTALS

	Aug. 28	Wk. ago
S&P 500 Dividend Yield	1.34%	1.35%
S&P 500 P/E Ratio (Trailing 12 mos.)	32.0	32.4
S&P 500 P/E Ratio (Next 12 mos.)*	20.9	20.8
First Call Earnings Revision*	-2.56%	-4.80%

*First Call Corp.

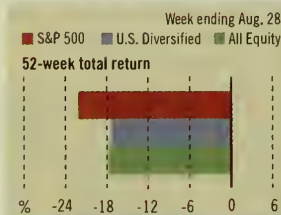
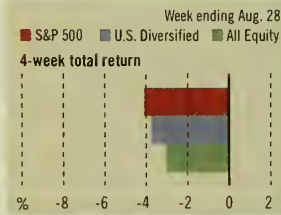
TECHNICAL INDICATORS

	Aug. 28	Wk. ago
S&P 500 200-day average	1256.2	1262.4
Stocks above 200-day average	62.0%	62.0%
Options: Put/call ratio	0.70	0.79
Insiders: Vickers Sell/buy ratio	2.82	3.01

WORST-PERFORMING GROUPS

	Last month %
Dil & Gas Drilling	-21.6
Specialty Appr. Retailers	-17.5
Automobiles	-16.3
Entertainment	-13.1
Dil-Well Equip. & Svcs.	-12.5

Mutual Funds



Data: Standard & Poor's

THE WEEK AHEAD

PURCHASING MANAGERS' INDEX Tuesday, Sept. 4, 10 a.m. EDT ► The National Association of Purchasing Management's August index of industrial activity probably inched up to 44%, from 43.6% in July. That's according to the median forecast of economists surveyed by Standard & Poor's MMS, a division of The McGraw-Hill Companies.

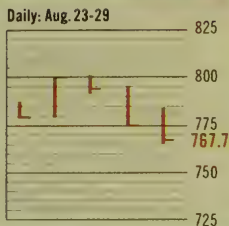
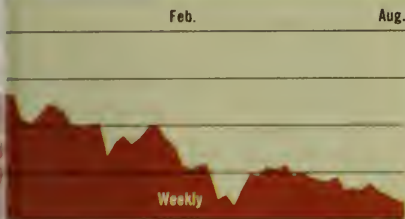
CONSTRUCTION SPENDING Tuesday, Sept. 4, 10 a.m. EDT ► Building outlays in July probably remained unchanged after tum-

bling 0.7% in June. Over the third quarter, residential construction is expected to slip 1%, while commercial construction outlays are expected to fall 13%.

VEHICLE SALES Wednesday, Sept. 5 ► Sales of U.S.-made and imported cars and light trucks probably totaled an annual rate of 16 million units for August, down from 16.2 million in July and the second-quarter rate of 16.6 million. While vehicle sales have softened, monthly totals are still healthy. One rea-

son: Dealers continue to offer large rebates and incentives.

EMPLOYMENT Friday, Sept. 7, 8:30 a.m. EDT ► Nonfarm payrolls likely dropped just 5,000 jobs in August, after 42,000 cuts in July. Manufacturing is expected to show a decline of 28,000 jobs in August, following a loss of 49,000 jobs in July. The unemployment rate likely will rise to 4.6% in August, and the average work week probably slipped to 34.2 hours from 34.3 hours in July.

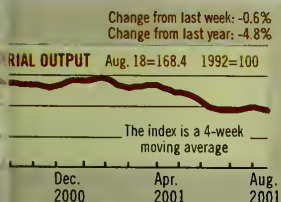


all 2.0%, a smidge more than the overall market. Provident Financial led the decline, down 11.0% criticized the subprime lender for how it accounts for bad loans. Other banking companies also on analysts' neutral ratings: Capital One Financial fell 5.9%, FleetBoston Financial fell 5.1%, and Mutual slipped 9.1%. EMC, Calpine, and Dynegy were standouts in an otherwise dismal week.

COMPANY PERFORMANCE

% change			% change			
Company	Week	Since 3/1/01	Rank	Company	Week	Since 3/1/01
International	-0.5	-4.1	26	Verizon Communications	-4.8	3.2
Petroleum	-2.4	-16.3	27	Citigroup	-1.2	-4.5
	9.6	-24.1	28	Sun Microsystems	-1.8	-33.1
	5.1	-6.7	29	Merck	-5.7	-15.8
Materials	-0.3	-3.5	30	El Paso	2.6	-29.1
Financial	-11.0	-21.7	31	Altera	-2.4	10.5
Petroleum	1.3	16.9	32	Marsh & McLennan	-4.4	-11.7
	-4.1	-18.6	33	Household International	-7.3	3.9
Tele	-2.4	-7.9	34	Chevron	-0.2	5.7
	-8.8	-37.5	35	SBC Communications	-1.9	-8.9
Brothers Holdings	1.2	-3.6	36	Mercury Interactive	-7.0	-50.9
	5.0	-62.1	37	AOL Time Warner	-2.5	-12.5
	4.3	-34.9	38	Washington Mutual	-9.1	10.0
Laboratories	-0.7	10.3	39	General Dynamics	-0.1	19.7
Financial	-5.1	-11.8	40	Comcast	-1.5	-14.8
Technology	0.8	4.6	41	Morgan Stanley Dean Witter	0.7	-15.3
	-2.7	-8.6	42	Tellabs	0.8	-68.3
Hess	1.9	7.9	43	Exxon Mobil	-0.8	-0.8
Dynegy	-0.3	-6.0	44	Scientific-Atlanta	-2.7	-55.1
Communications	-3.2	-61.5	45	U.S. Bancorp	-3.4	3.9
Financial	-5.9	1.6	46	Paychex	-1.7	-3.8
Petroleum	1.5	9.3	47	Merrill Lynch	1.1	-13.5
Devices	2.4	18.3	48	Bed Bath & Beyond	-0.1	13.5
Sources	-4.5	-26.2	49	Texas Instruments	1.2	5.1
Health	-2.8	9.4	50	Teradyne	6.5	8.2

Production Index



Production index fell again in the latest week. Below the four-week moving average, the index fell from 167.7 to 166.5. After seasonal adjustment, the index was pulled down by a steep decline in steel, and auto production were all high, while coal remained unchanged.

For more information on the production index, visit www.businessweek.com. Copyright 2001 by The McGraw-Hill Companies.

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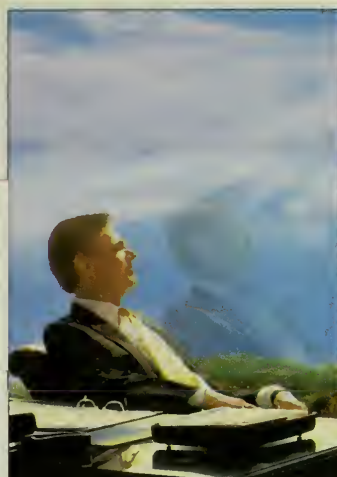
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MINOLTA

The essentials of imaging

As he looked out over the perfectly manicured grass of the driving range at Augusta National, perhaps Sam Snead wasn't really there. Perhaps, in his mind, he was a kid again, sneaking in a quick three on an overgrown course so steep that it was nicknamed "The Goat Course." Either way, he was swinging like he was a kid.

At 8:35 A.M. on Tuesday, April 3, 2001, Sam Snead stepped onto the range to hit a few balls and to say a few hellos. He ended up putting on a swing clinic.

Few golfers swing sweet enough to make people stop and take notice. Only one can still do it at the age of 89.

As Sam took his place and started to hit, one by one, Palmer, Watson, Faldo and every other pro put their clubs down and gathered around, showing their profound respect and admiration for the greatest swing in golf history.

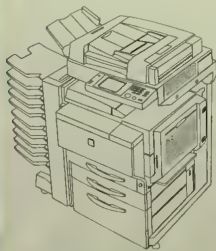
As ball after ball sailed into the sky, Sam raised his head and watched every ball find a home in that great green expanse of grass.

He later admitted that at his age he couldn't see exactly where they landed. But he didn't need to.

"All I saw was green. But I could *feel* they were all good."

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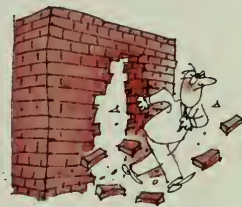
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FOCUS ON GROWTH, NOT THE SURPLUS

The debate in Washington over who "lost" the budget surplus is rife with political deceit and devoid of economic truth. A rare example of fiscal policy acuity is being twisted into a political blame game. Democrats and Republicans alike are claiming that nothing less than the financial integrity of Social Security is at stake. This is utter nonsense. It is time to stop the political finger-pointing and acknowledge that with consumer confidence falling and the economy skirting recession, the focus of government policy should be on growth, not some particular level of the budget surplus or some notion of a "lockbox." Tax cuts that promote economic growth are the correct course of government action, even if they result in a lower budget surplus.

The sharp decline in that surplus simply means that Washington has got the direction of its short-term fiscal policy right. The drop in the surplus is due in large part to the tax rebate checks going out to millions of Americans. This is putting money in consumers' pockets. A one-percentage-point cut in the top income-tax bracket, a shift in corporate tax payments, and the economic slowdown account for the rest of the decline in the surplus.

In most economic downturns, it takes politicians so long to pass any tax cuts that they usually come too late in the business cycle to have any positive effect. Not this time. Driven by the Bush Administration, Congress passed a front-loaded tax cut bill that kicked in as the economy slowed. It

should be applauded for its action on taxes, not derided for "losing" the surplus.

The long-term health of Social Security and Medicare can be guaranteed only by strong economic growth. The current political debate over the surplus should be recast in terms of what fiscal policy is best suited to generating growth over the next decade. Through this lens, there are legitimate grounds to rethink the tax bill passed by Congress. The tax cut is well designed to deliver a short-term Keynesian kick, but it turns out to be poorly fashioned to generate long-term economic growth. As it now stands, the tax code lacks consistency and predictability, two key elements in providing incentives for individuals and businesses to save and invest. It dribbles out cuts in marginal rates over many years so that taxpayers have to wait until 2004 for the next one and 2006 for a final cut to 35%. And then, believe it or not, everything reverses in 2011. The income tax, the inheritance tax, and marriage penalties all revert back to the high levels of 2000. This is clearly not the optimal way to cut taxes and help individuals and businesses make investment and spending plans for the years ahead.

Five new Congresses and at least two Presidents will have a chance to change the tax bill and attack this problem. If they're wise, they won't get hung up on short-term swings in the surplus. Politicians must remember that in the end it is growth that matters most.

KEEP POLITICS OUT OF IMMIGRATION POLICY

The outline for a far more rational immigration policy for the U.S. may be taking shape. There is a long way to go, but a meeting between President Bush and Mexican President Vicente Fox in Washington could be the beginning. The U.S. attitude toward immigration is undergoing a sea change, with Federal Reserve Chairman Alan Greenspan leading a chorus singing the praises of immigrant contributions to economic growth. It is now clear that without the biggest immigration wave in its history, the U.S. would not have been able to achieve the high growth rates of the '90s. The Bush-Fox meeting promises to open a dialogue that could lead to reform of American immigration policy, shifting it away from a system based on quotas, family, and policing toward one aimed at international negotiations that meet the labor needs of the U.S. and other countries. This could be a welcome breakthrough.

But there is a danger: politics. President Bush's political advisers have made no secret of his desire for Republicans to capture a greater share of the Hispanic vote. Legalizing illegal immigrants in some fashion could attract such votes. And President Fox has said he wants to allow the 8 million Mexicans living in the U.S. to vote in Mexico as well, hop-

ing his party will attract many of them. Shaping a new immigration policy around such political aims is the wrong way to go. It not only discriminates against Asians and Europeans who might want to immigrate to America but also undermines a key goal of immigration—fostering economic growth.

Right now, the U.S. has a bifurcated immigration system. Legal immigrants are allowed into the country based on family ties and national quotas. Only a tiny sliver, under the H-1B visa program that focuses on high-tech workers, enters to satisfy specific labor needs. Ironically, it is illegal immigration that provides added flexibility to the U.S. labor market and helps meet severe labor shortages in the service, construction, and other industries.

Fox and Bush are starting discussions that could lead to a comprehensive agreement. On the table are visas for guest workers, amnesty for illegal workers, a safer border, and more U.S. business investment in Mexico to increase jobs.

For the first time, Washington would negotiate immigration as it does trade, on a quid pro quo basis. And it would do so within an economic framework. If politicians can restrain themselves, this is the way to go.



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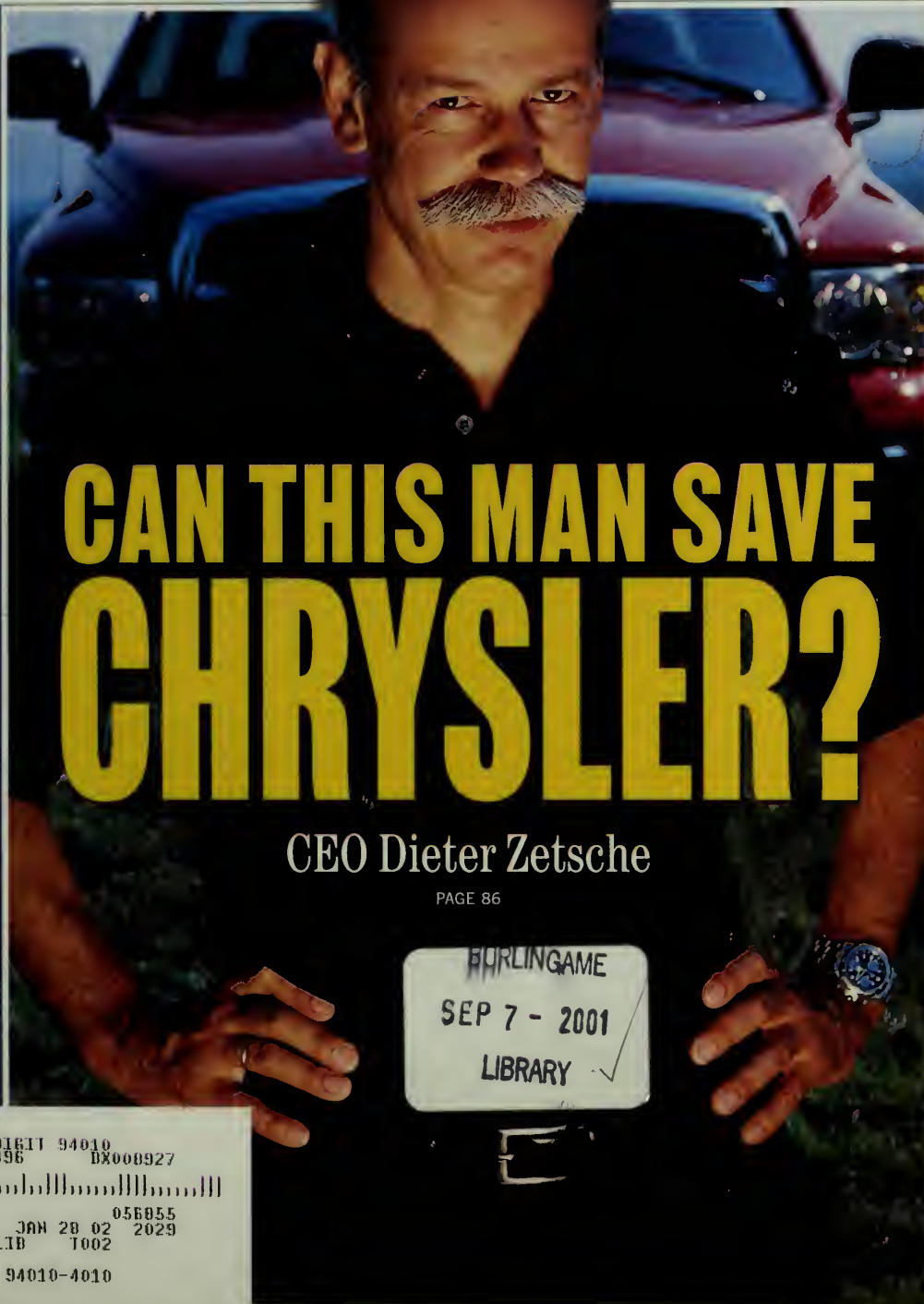


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CAN THIS MAN SAVE CHRYSLER?

CEO Dieter Zetsche

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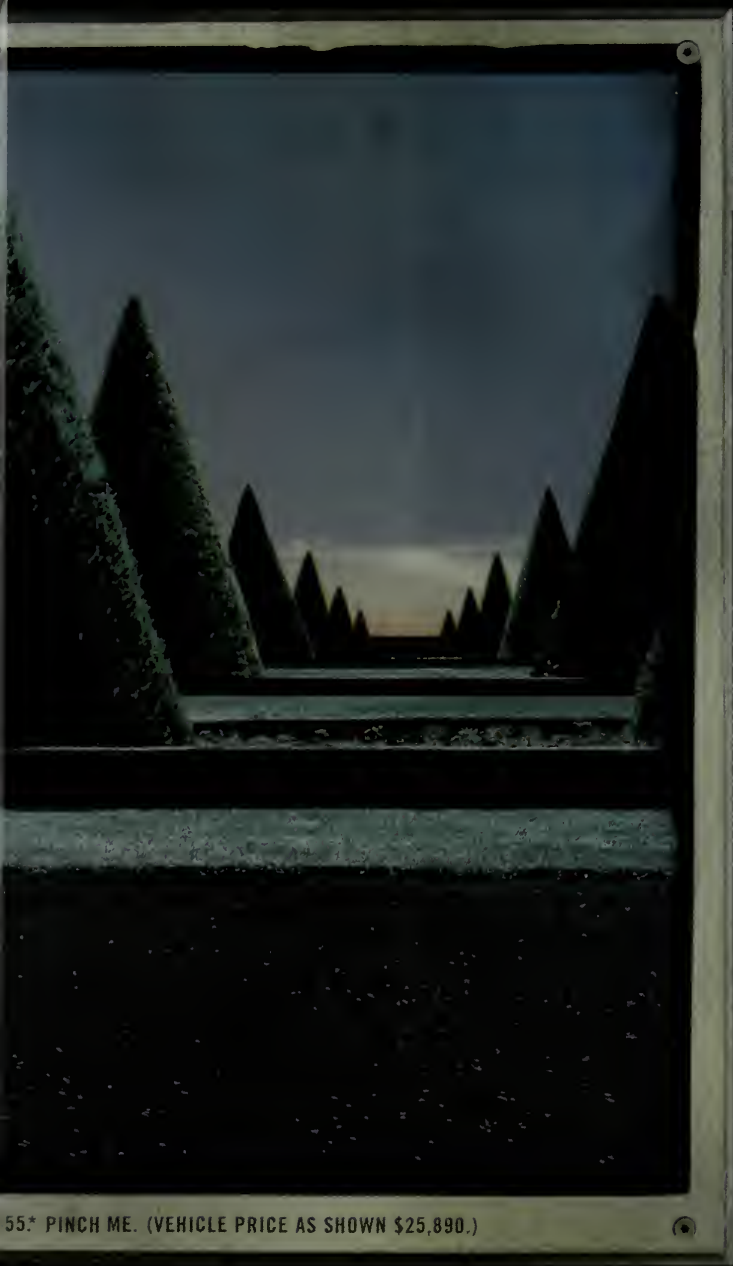
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Three years after the merger, DaimlerChrysler's U.S. unit is still running rough: As a result, the company's stock is down 55%, and profits in 2000 tumbled 90%. And few new models will surface till 2004. Oddly enough, CEO Dieter Zetsche may be just the white knight the situation requires. The German exec has confounded his many American critics by turning out to be a decent, even likable, fellow. He has the unions' support. And who knows, he may even get Stuttgart and Detroit to cooperate in their carmaking operations

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Sugar High

Krispy Kreme's stock continues to confound the skeptics. But its sweet share price can't keep rising forever, can it?



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HARD TIMES

WHERE THE JOBS ARE



SINCE JAN. 1, SILICON VALLEY'S 2.2% UNEMPLOYMENT RATE has doubled, the manufacturing slump has hiked Detroit's jobless rate to 10%, and 13 million first-time unemployment claims have been filed. But job creation is not all doom and gloom in this downturn. In fact, in many Sunbelt regions—especially those where tourism and farming are big—job growth is coming along quite nicely.

Out-of-work dot-commers may not yet be willing to pick fruit, but the No.1 region for job growth is now California's Visalia-Tulare-Porterville region in the Central Valley, with 5.36% job growth between July, 2000, and July, 2001, according to the U.S. Bureau of Labor Statistics. Benefiting from strong agricultural prices, the region is the top U.S. dairy producer and a major fruit and vegetable grower.

The second-largest job creation area is Tampa-St. Petersburg-Clearwater, where an influx of affluent retirees and tourism have spurred job growth by 4.53%. Las Vegas, thanks to tourism and conventions, is No.4 at 4.08%. In fact, tourism helped land 15 Sunbelt spots in the top 20 job-creation areas. "Domestic tourism has held up despite the job market softness," says Mark Zandi, chief economist at Economy.com. Maybe Americans figure that they had better take that vacation while they still have a job. *Ann Therese Palmer*

HELP WANTED

Thanks to tourism, farming, and retirees, many areas in the Sun Belt had high job growth rates from July 2000, to July 2001:

1 VISALIA-TULARE-PORTERVILLE, CALIF.

JOB GROWTH 5.27%
Agricultural output is among the strongest in nation

2 TAMPA REGION, FLA.

JOB GROWTH 4.53%
Business travel, tourism booms

3 KENOSHA, WIS.

JOB GROWTH 4.18%
Migrating Chicago businesses find lower costs



4 LAS VEGAS

JOB GROWTH 4.08%
Tourism strong

5 SAN LUIS OBISPO AREA, CALIF.

JOB GROWTH 3.81%
Wineries, a university, and a prison are hiring

6 LAREDO, TEX.

JOB GROWTH 3.71%
NRTA-related traffic means federal agencies are expanding

7 WEST PALM BEACH-BOCA RATON, FLA.

JOB GROWTH 3.69%
Health-care companies get federal dollars

8 FORT MYERS-CAPE CORAL, FLA.

JOB GROWTH 3.6%
Influx of wealthy retirees prompts job growth

9 SHEBOYGAN, WIS.

JOB GROWTH 3.56%
Major employer Kohler Co. is booming

10 DALLAS

JOB GROWTH 3.46%
International shipments through Dallas boost jobs

TALK SHOW "Out of the top 100 companies on Nasdaq, half of them will not be around five years from now."

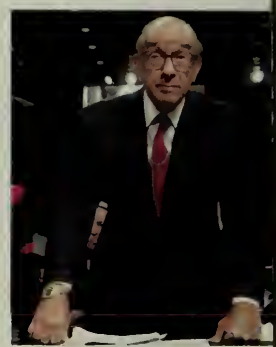
—Cisco Systems CEO John Chambers, at a business conference in Tokyo

THE GREAT TAX REBATE

GREENSPAN: I TOLD YOU SO—IN 1950

WHEN THE COMMERCE DEPT. said on Aug. 30 that consumer spending barely rose in July, despite the tax rebate, stock prices swooned as investors fretted that the much-hyped refund wouldn't be enough to jump-start the sagging economy. At the Federal Reserve, however, Chairman Alan Greenspan wasn't surprised. Consumers were acting just the way he had predicted—in research carried out way back in 1950.

Fresh out of graduate school and working at the Conference Board, a consulting outfit, Greenspan sought to gauge the economic impact of \$2.8 billion in insurance dividends Uncle Sam was paying to Second World War veterans. He concluded, correctly as it turned out, that the cash would not have a



WARNS against quick boost

big immediate impact. Instead, the effect would be, in his words, "diffused over a longer period... (with) from one third to one half spent at stores within six months."

A lot has changed in 50 years, but Greenspan thinks his earlier work shows that spending habits haven't. That means that the \$40 billion tax rebate should indeed boost growth—just not as fast as much as some investors would like. *Rich Milne*

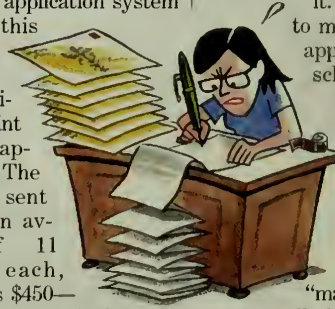
MED SCHOOL BLUES

IS THERE A DOCTOR IN THE WEB?

MORE THAN 35,000 APPLICANTS for U.S. medical schools have found that the admissions process needs emergency surgery: A new, mandatory Web-based application system collapsed this summer, forcing many applicants to print and mail applications. The applicants sent forms to an average of 11 schools each, which costs \$450—

says one applicant, who didn't want her name used for fear of ruining her chances. She still doesn't know whether any schools have received her applications. The system, working better now, says Pamela Cranston of the American Association of Medical Colleges, which oversees it. The AAMC voted to mail all complete applications to medical schools.

And what about refunds for applicants who will spend about \$14 million of their applications? They "may have not gotten all the services they paid for," Cranston says. Refunds are under consideration, "but no decision has been made." *Paul Raeburn*



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Progress Energy

Up Front

AS THE DOWNTURN TURNS

THE GREAT SHOPPING-CART ROUNDUP

IN AN ECONOMIC SLUMP, BUSINESS costs that were once low priority take on new importance for the bottom line. In this case, it's shopping carts. An average cart costs \$100, and the National Grocers Assn. says retailers worldwide lose \$800 million annually to cart theft.



Some retailers are taking action. At a Wal-Mart Stores Supercenter in Nashville, posters encourage customers to return carts for a chance to win a TV. "You bring back 30 carts, you can get 30 entries," says Assistant Manager Ben Bennett. Now, the usual 300 carts left outside daily are down to 100. And, in true Wal-Mart fashion, "it's lowering payroll," says Bennett, who reports scheduling 100 fewer hours per week for \$8-per-hour cart-roundup jobs.

The television costs Wal-Mart just \$169.88.

Some retailers and even cities are hiring private companies as cart shepherds. Last month, Hernandez Cart Service in Anaheim, Calif., signed a \$48,000 annual contract with the city. It says it rounds up 7,000 carts a day. California Shopping Cart Retrieval (CSCR), a nonprofit formed by 73 retailers such as Albertson's and Rite Aid, estimates that major chains from Fresno to the Mexican border spend \$8 million annually to corral carts. CSCR expects to rustle up 6.1 million this year.

Aiming to eliminate the problem altogether, Kroger, the nation's largest grocer, has installed new devices at 100 stores—invisible electric fences at the parking-lot perimeter that zap the cart, not you, freezing the front wheels. At \$17,000, the electric zapper is a one-time cost. "Some companies are seeing a return on investment within 60 days," says Barry Gallace of fencemaker Cartronics. That's nice, but could somebody now figure out how to fix all those wobbly wheels? *Brian Grow*

DRAWN & QUARTERED

THEY DIRECT THEIR ADVERTISING AT TEENAGERS, GET 'EM HOOKED, AND THEN THEY'VE GOT LOYAL CUSTOMERS UNTIL THEY GO BANKRUPT.



CHANGING CHINA

FENDING OFF THOSE KILLER TVs

A SCARE CAMPAIGN IN THE Chinese media has Shanghai newspapers reporting that appliances such as computers and TVs may emit harmful radiation. So mothers-to-be are snapping up expensive radiation-proof clothing. At \$165 for a simple smock, the clothes cost half the average white-collar monthly salary. But many say it's worth it. "Maybe the clothes won't make that much difference, but it will put my heart at ease," says Sarah Ge, 26, eyeing the tan-and-olive-green industrial-strength items at an upscale shopping center on Nanjing Street.

Made with metal ions, the clothes resemble those in Dickens' workhouses. Shanghai Lion, which started making them in 1999, is the most popular brand. Its sales are



HOT TREND:
Radiation-proof clothes

forecast to rise 10% this year, to \$870,000. And four more companies have jumped in. Office workers and college students who spend hours in front of computers are also buying the clothes, says Shanghai Lion saleswoman Yang Beizhen.

Despite public concerns doctors are skeptical. Says Dr. Wang Yonghong of Shanghai Children's Hospital, "The radiation in our daily lives is always within safe limits." Chalk up the scare to the rapid pace of change in China. *Alysha Webb*

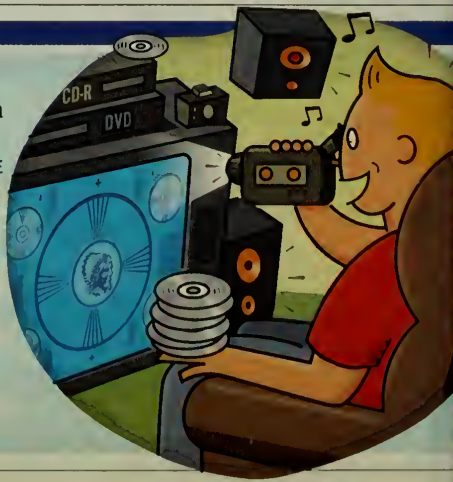
THE BIG PICTURE

STILL GOTTA HAVE IT

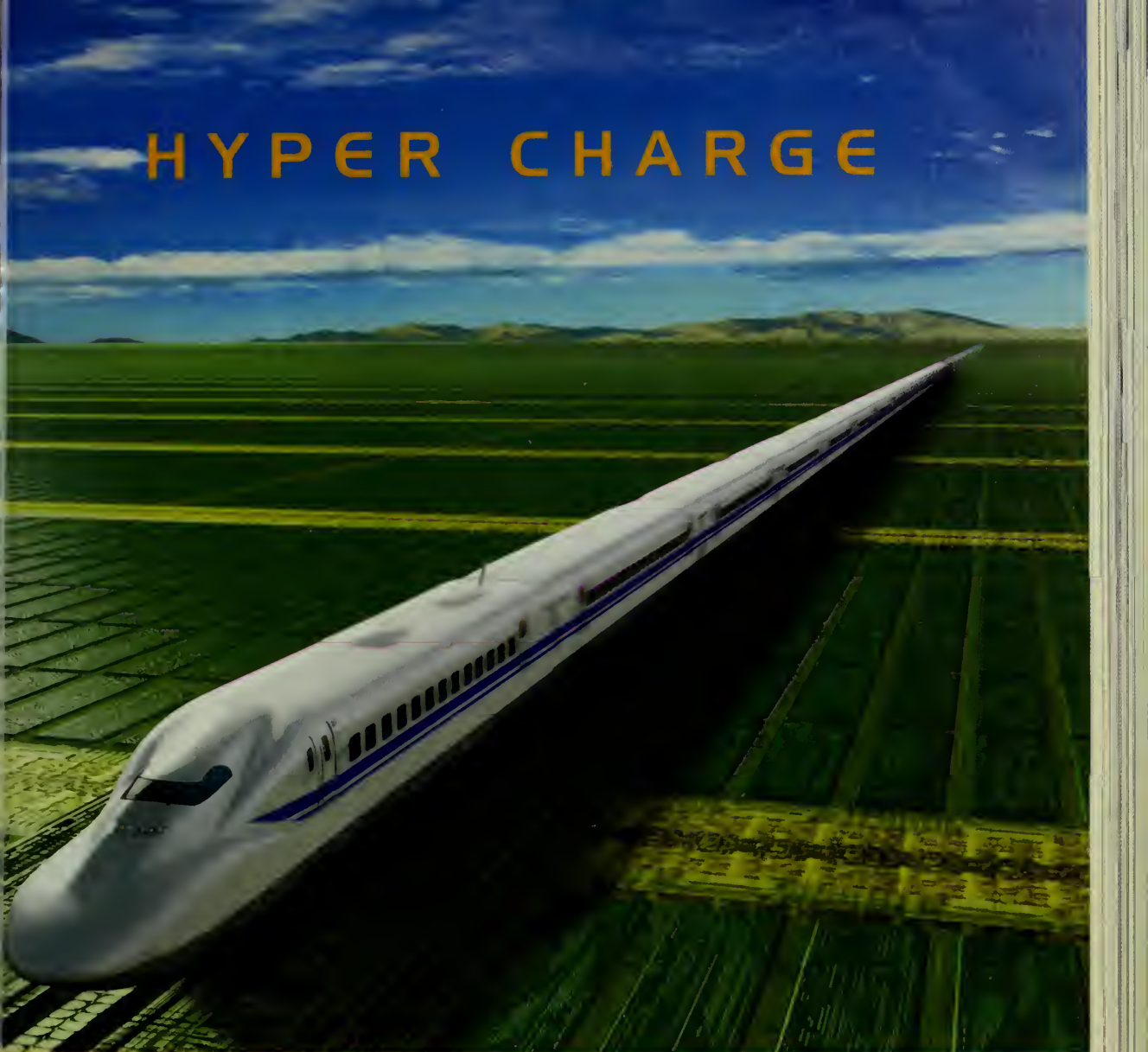
Despite a slumping economy, consumers are still eager to get their hands on the latest audio and video gear. And why not? It's mostly cheaper now.

CATEGORY	2001 UNIT SALES*	PERCENT CHANGE FROM 2000	2001 AVERAGE SELLING PRICE	PERCENT CHANGE FROM 2000
DIGITAL TELEVISION	325,000	230%	\$2,477	-31%
DVD	3,450,000	94	205	-25
DIGITAL CAMERA	3,500,000	66	286	-19
MP3/DIGITAL MUSIC PLAYER	125,000	59	212	-2
HOME THEATER SYSTEM	425,000	49	483	+22
HOME CD BURNER	125,000	47	374	-20
DIGITAL CAMCORDER	475,000	43	808	-16

*PROJECTED ESTIMATEData: Industry estimates, NPD Intellect Market Tracking



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TWO PROPOSALS TO BRIGHTEN AMERICA'S FUTURE

"Governing a nation divided" ("America's Future," Cover Story, Aug. 20-27) analyzes the value divide that separates neighbor from neighbor. Yet the story overlooks another divide that, while appearing subtle, is massive. Many of us who want government to focus on quality-of-life concerns and social tolerance emphasize religious faith just as much, and perhaps more, than your second group, who want some kind of cultural purification.

It's time to realize that the Christian Right and Moral Majority have no monopoly on Christianity, nor any basis on which to claim a superior morality. I am a fiscal conservative who believes that people often do need help. They need compassion in the true meaning of the word. And to use the elder George Bush's words, the nation needs a kinder, gentler world. Indeed, I am one of those who, like Vermont Senator James M. Jeffords, was long ago driven from the Republican Party.

David G. Pritchard
 Edgartown, Mass.

There is a simple solution to the "College crunch" ("America's Future," Cover Story, Aug. 20-27): Reintroduce the draft and provide a new GI Bill for education. This solves the recruitment problem and the education problem. The draft is minority- and color-blind. It could even be gender-blind.

Of course, one can always work in the daytime and get a degree attending school at night, as I did. How about a

study to determine why the cost of college education so outpaces inflation?

Edwin P. Ha
 Manahawkin, N.J.

GM MUST NOT OVERLOOK QUALITY

It was good to see that General Motors Corp. has brought Robert A. Lutz on board; his automotive expertise is legendary ("Can Lutz help steer GM out of its slide?" News: Analysis & Commentary, Aug. 20-27). What GM needs, however, goes far beyond technical and financial expertise. GM needs to be looking at who is not buying its vehicles. For many car buyers, the company's name still evokes the days of CEO Roger Smith and interchangeable engine and other excuses for not buying. Maybe I'm a sentimentalist, but I don't want to see an old American company—one that has meant so much to so many people for nearly 100 years—dropping brands and heading toward second-rate status. Bob Lutz created the right sentiment for Chrysler; maybe he can help GM as well.

Charles Rettstadt
 Doylestown, Pa.

Lutz and the other big hires will have to do more than spruce up GM's designs in order to regain market share. The new Cadillac CTS and other model changes will have very little effect unless GM buckles down to improve the quality of its products. As a longtime customer—for Chevys, Buicks, and Cadillacs—I have watched GM fall behind in product reliability and durability and just never quite get with it. Final



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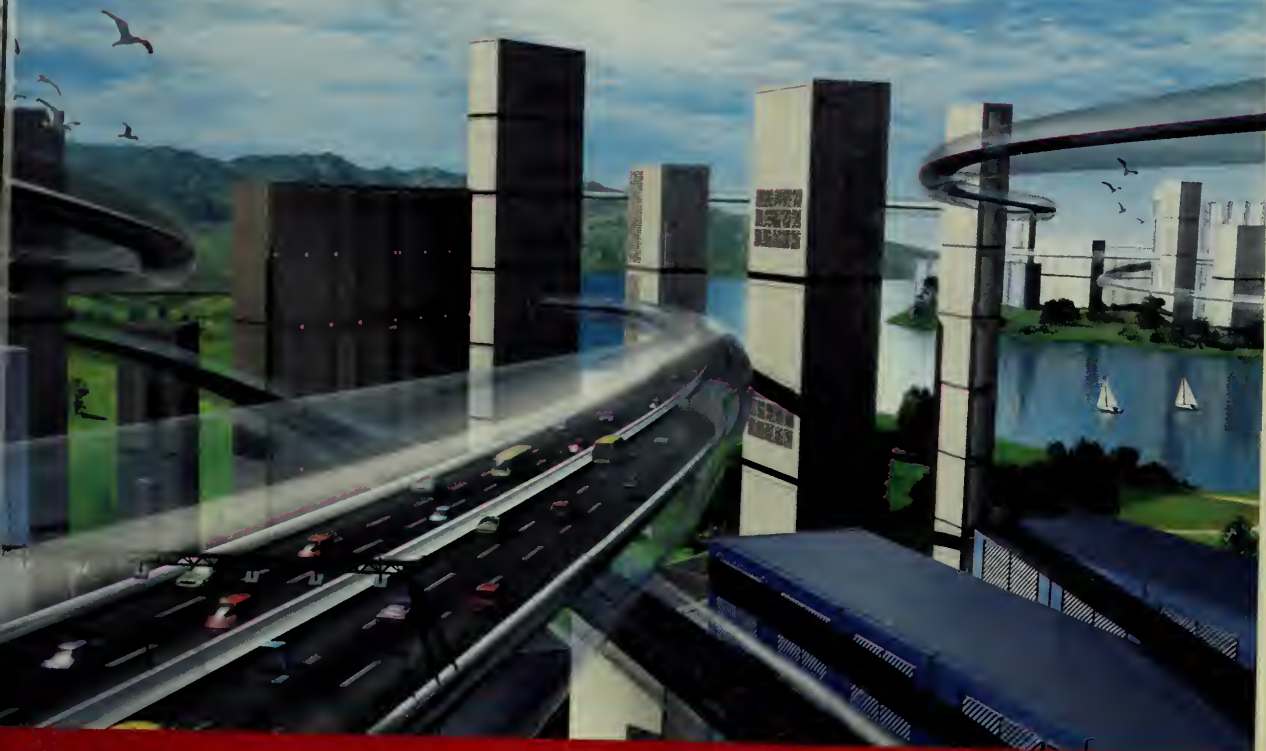
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IT USED TO BE ABOUT SURROUNDING YOURSELF
WITH TALENT.

IT STILL IS.



CORRECTIONS & CLARIFICATIONS

"The most fuel-efficient that you can be" (Science & Technology, Sept. 3) erred in stating that a 50% increase in fuel efficiency would double the range of an Abrams tank. It would extend the range by 50%.

this year, I threw in the towel and reluctantly invested in a Lexus.

Allan C. Strayer
Westlake Village, Calif.

HOW TO COUNT HIGH-TECH WORKERS

I applaud the University of Minnesota's use of more precise criteria to measure high-tech employment ("Rust belts? Try tech belts," Science & Technology, Aug. 13). Using similar methods, I conducted a study at the University of Michigan ranking the states' high-tech workers. In it, a different picture of the so-called Rust Belt emerges. Michigan, for example, is No. 7 in the country in total high-tech employment, taking into account about 60,000 high-tech employees in the automotive industry.

After all, should a janitor at Microsoft be considered a high-tech worker? I don't think so. But should a systems analyst at General Motors, Ford, or DaimlerChrysler be counted? You betcha. I am glad that the University of Minnesota's study agrees.

Sean McAlinden
Center for Automotive Research
Ann Arbor, Mich.

THE DOLLAR IS BADLY OVERVALUED

"Trust the strong dollar" (Editorials, Aug. 13) totally misses the point. There is a difference between a strong dollar and an overvalued dollar—and the U.S. dollar is badly overvalued. The nearly 30% increase in the value of the dollar in the past four years puts it into territory seen only once before in the past quarter-century. This is decimating American manufacturing.

Even the most outstanding companies, such as those that have won the U.S. President's "E" Award for exporting excellence and building exports to more than half their business, are now finding their exports vanishing. Many are getting no new export orders whatsoever and are finding they can't even hold on to their domestic markets. In total, our manufactured-goods exports are off \$50 billion from last year—a loss

that translates into 650,000 lost jobs.

This goes beyond manufacturing. It has also placed our economy on an import binge that has generated an unsustainable current-account deficit approaching 5% of our gross domestic product. Even the International Monetary Fund points out things have gone too far. If a dollar decline cannot be managed smoothly, the kind of "chaotic crash" your editorial warns against is a real concern. The worst thing would be to have President Bush and Treasury Secretary Paul H. O'Neill simply "stand by the dollar without qualification," as *BusinessWeek* recommends.

Franklin J. Vargo
National Association of Manufacturers
Washington

NAFTA: GOOD MEDICINE FOR EVERYONE

United Auto Workers President Stephen Yokich's letter (Readers Report, Aug. 13), written in response to "NAFTA's scorecard: So far, so good" (Economics, July 9), demonstrates how trade statistics can be misused. It is true that the U.S. trade deficit with Mexico in automobiles and auto parts almost doubled from 1996 to 2000, going from \$5.7 billion to \$10.3 billion. But U.S. exports in these categories more than doubled as well, growing from \$4.9 billion to \$10.1 billion in this period. Meanwhile, the value of exported motor vehicles alone more than tripled, from \$868 million to \$2.8 billion.

Even assuming productivity gains, these figures demonstrate that the North American Free Trade Agreement has meant more, not fewer, jobs for UAW members. Of course, it has also meant more jobs for Mexican workers, which has led to faster economic growth in Mexico and higher demand there for U.S. exports, including automobiles. The rising tide really has lifted all boats.

Thomas M.T. Niles
U.S. Council for International Business
New York

MEXICO CAN'T LET THIS CHANCE SLIP BY

"Is the magic starting to fade?" (International Business, Aug. 6) comes at a time when many, both government officials and private individuals, are working to convince President Vicente Fox's government that Mexico should find its place in the world, not only for the sake of jobs but as contribution to human knowledge and advancement.

The cheap part of the *maquiladora*

sector is fading away, and this should be viewed as an opportunity. As president of the services section of the Mexican Association of Information Technology Industries, I can tell you that GMAT and Roberto Solís are not alone in the quest to convert Mexico into a software powerhouse. For two years, we've been working with several government branches at the federal and state level and we see programs already coming into place, especially from Bancomer, our export-import bank.

This is the golden opportunity to develop and expand our relatively small national software-development industry. If we can work cohesively as a country in five years we'll be recognized as a country of choice for software development. If not, we'll lose this opportunity forever to countries like India. We'll be doomed to the wrong side of the digital divide, with no important employment in the area, no balanced market, and with nothing to say.

Rafael Bernier
Mexico City

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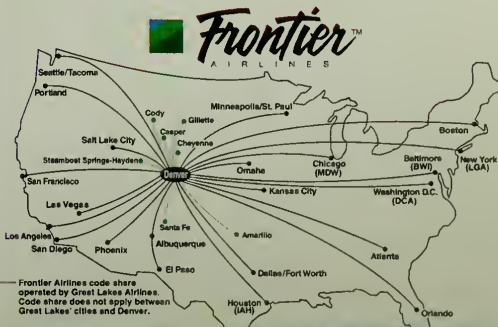
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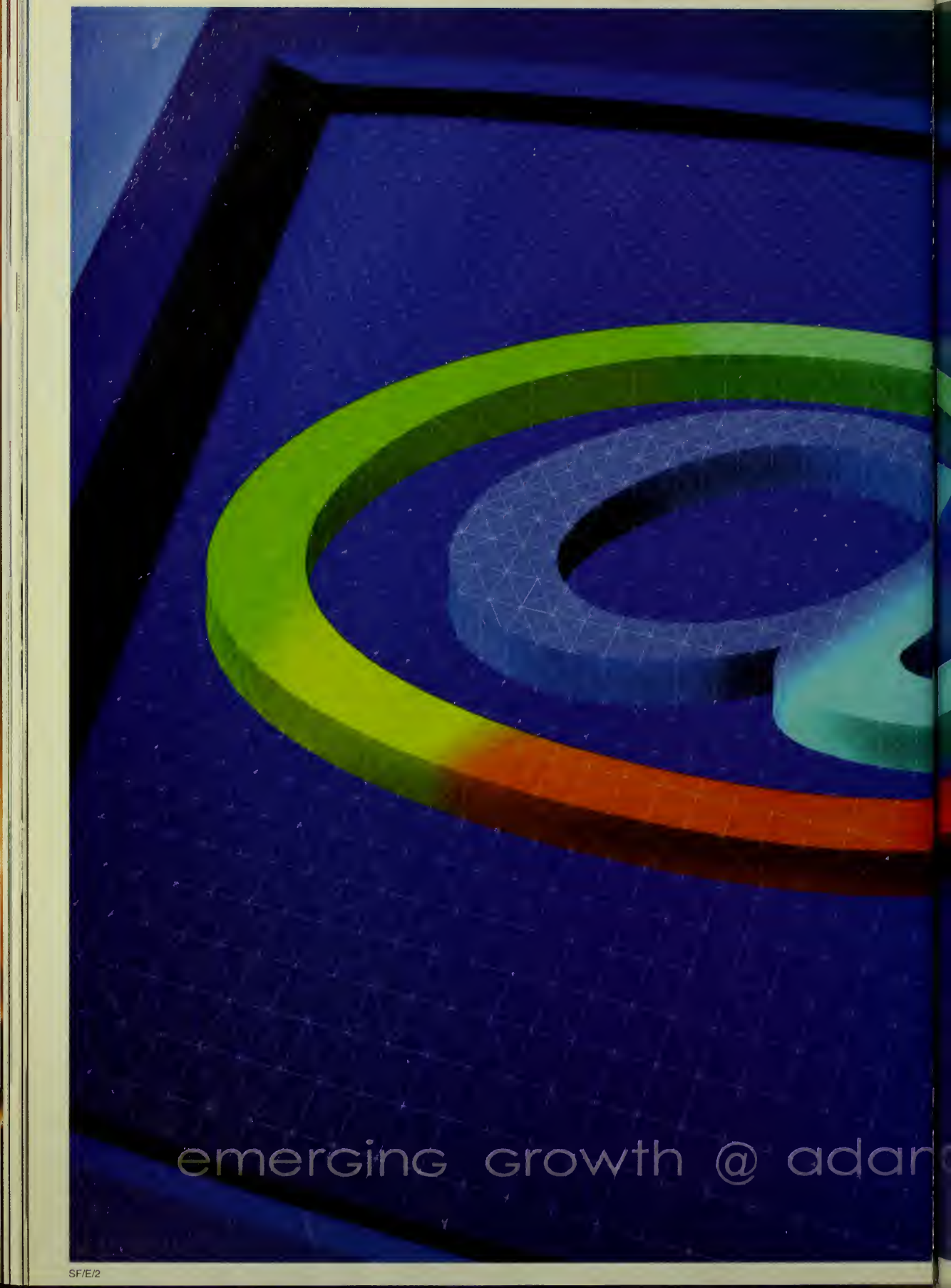
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BY STEPHEN H. WILDSTROM

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DELUXE LAPTOPS THAT WORK ANYWHERE



Wireless LAN means you don't need a network jack, but the setup is unnecessarily complicated

The history of new technology in laptops follows a familiar pattern: First, a feature is offered as an add-on, usually in the form of a PC Card. Then it is integrated into high-end models. As volumes rise and prices fall, it becomes standard throughout the product line. Modems followed this course and are now universally included in laptops. Built-in Ethernet, which makes for convenient office or home networking, has nearly completed the transition. Wireless local networking, known as Wi-Fi or 802.11b, has just begun the cycle, with most Windows-laptop makers including integrated wireless on some models. Apple Computer laptops have offered it for some time.

A wireless LAN lets you work where you want, not just where there's a network jack. You can carry your laptop into a conference room or move it around a classroom and stay on the network. At home, you can get Web access anywhere without running cables. Building in wireless has some considerable advantages. It's more convenient, more reliable, and cheaper. Instead of awkwardly sticking out of the laptop, antennas are hidden away, usually inside the lid, a position that is, at least in theory, more efficient.

I looked at two high-end wireless notebooks, the OmniBook 6100 from Hewlett-Packard (www.hp.com/notebooks/) and a ThinkPad T23 from IBM (www.thinkpad.com). These are both impressive notebooks sporting Intel's newest 1.13 gigahertz Pentium III-M processor. To be honest, there's no detectable performance difference between these chips and the older 900 MHz Pentium III in typical notebook tasks. But the III-M runs cooler and draws less power. Both notebooks demonstrated impressive battery life: Running Windows 2000, I got a bit over three hours in the ThinkPad and well more than four in the HP, which sports a bigger, heavier battery.

Another novel feature of these deluxe laptops is their high-resolution 1400-by-1050 pixel displays. These are a mixed blessing. On the

ThinkPad's 14.1-in. display, unless adjustments are made, icons and text are 27% smaller than the same computer with a 1024-by-768 display. Depending on your eyes, it can be hard to read some Web pages and e-mail messages, whose type size cannot be changed. Things are a bit better on the OmniBook's 15.1-in. display, but the result is a bigger notebook. The OmniBook has little chance of being usable in a coach airplane seat.

The wireless performance also varied widely between the two computers, which surprised me, since they use the same Actontec Electronix wireless hardware and software. The IBM, the apparent beneficiary of superior antenna design, was the clear winner, maintaining an 11-megabits-per-second connection in a marginal reception area where the HP was unable to link to a base station. In fact, the HP did not do as well as a laptop with an Agere Systems Orinoco PC Card. **ONE GLITCH.** The wireless software could use improvement in both computers. Each requires you to enter an encryption key as a hexadecimal (base 16) number, which requires a complicated conversion if you want to work on a network that expects an ordinary character string as a key. IBM includes a handy program that makes it easy to set up and switch among network profiles so that you can easily move from your office to a high-speed hotel Net connection. But it hand-

TWO WIRELESS WORKHORSES

HEWLETT-PACKARD OMNIBOOK 6100

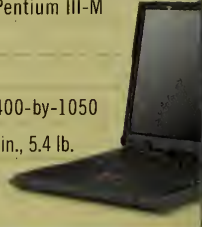
1.13 GHz Pentium III-M
256 MB
30 GB
15.1 in., 1400-by-1050 pixels
12.8x10.4x1.4 in., 6.2 lb.
\$3,599



Data: Hewlett-Packard

IBM THINKPAD T23

PROCESSOR 1.13 GHz Pentium III-M
MEMORY 128 MB
STORAGE 48 GB
DISPLAY 14.1 in., 1400-by-1050
SIZE 12x9.8x1.3 in., 5.4 lb.
PRICE \$3,349



Data: IBM

only basic network settings, not the addition and confusing wireless setup, so you may have to struggle to get your laptop connected to the wireless service in an airport lounge.

The market for \$3,500 laptops is obviously limited, but integrated wireless is already spreading downmarket. Compaq Computer offers a novel wireless snap-on module as a \$189 option on its new, ultralight Evo Notebook N-400c starting at \$2,149. Wireless is growing rapidly in education, and most of the cheaper wireless models are aimed at the school market. Integrated wireless is a \$159 option on Dell Computer's Inspiron 4100 models, which start as low as \$1,199. Apple offers built-in wireless as a \$100 option both its high-end PowerBook Titanium and education-oriented iBook, which starts at \$1,299.

About that software: A setup wizard to explain the steps and end the need for obscurity, such as hexadecimal codes would go a long way toward making a great technology accessible.

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WIRELESS GEAR FROM DIFFERENT MAKERS IS SUPPOSED TO BE COMPATIBLE. It's not always that simple. See Technology & You at www.businessweek.com/technology/

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A photograph of a woman with short, wavy brown hair, wearing a dark blazer over a black top and a dark beaded necklace. She is standing on a city street, gesturing with her hands as if speaking. In the background, there are buildings, a street sign, and a car. The text is overlaid on the lower half of the image.

"The oil companies need to speak
frankly and honestly."

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JUDO STRATEGY

Turning Your Competitors' Strength to Your Advantage

By David B. Yoffie and Mary Kwak

Harvard Business School • 238pp • \$29.95

MARTIAL ARTS IN THE CORNER OFFICE

A couple of years ago, when he was visiting Japan, David B. Yoffie, a professor at Harvard Business School, became so ill with a fever that he could do nothing but lie in bed and watch television. Sumo wrestling seemed to be on all channels, so he spent a day watching nearly naked 300-pound men squat, throw salt over their shoulders, and then bash into each other with the force of freight trains colliding. "After eight hours, I still didn't get it," says Yoffie.

Well, Yoffie gets it now. In the past two years, he has made a careful study of the Japanese martial arts of judo and sumo and applied them as metaphors for the way companies do business. The result: *Judo Strategy: Turning Your Competitors' Strength to Your Advantage*. Written with Mary Kwak, a research associate at Harvard Business School, *Judo Strategy* is a lively, detailed analysis of how small companies can compete against larger ones. It also lays out ways big companies can use sumo tactics to bully rivals into submission—although the authors don't really seem to have their hearts in this side of the battle. While most of the examples come from the high-tech industry, Yoffie and Kwak range far afield to show that these techniques can apply in any industry.

While few of the executives mentioned in the book use martial arts lingo, the authors use the metaphors to make it easier for readers to understand these strategies. In judo, contestants move quickly to surprise opponents and neutralize their advantages. They stay balanced so they can respond nimbly to an enemy's attack. They get a grip and use their opponents' force against them to throw them to the ground. In sumo, intimidation often ends a match practically before it starts. Champion wrestlers make use of overpowering moves

such as slamming into an opponent, lifting him off his feet by the loincloth, and marching him out of the ring. You can readily see how these techniques are employed by the bare-knuckle capitalists of Silicon Valley. Intimidation? That's called FUD (fear, uncertainty, and doubt) in the tech realm, where it has been used for years by giants such as IBM and Microsoft Corp. to discourage potential customers from buying products of small-fry rivals.

Yoffie first used the judo and sumo metaphors when he was doing research for an earlier book, *Competing on Internet Time*, which chronicled the Web-browser war between Microsoft and upstart Netscape Communications Corp. Netscape operated like a judo master at first, in 1994, when it came out of nowhere to define a new market and leaped to a one-year lead over the software giant. But as time went on, Netscape tried to out-sumo Microsoft—challenging it for dominance of desktop computing. That brought the wrath of Bill down upon Netscape. Microsoft Chairman William H. Gates III used his company's cash hoard and its power over PC makers to demolish Netscape's daunting 90% market share. Ultimately, Netscape sold out to America Online Inc., the government sued Microsoft for using its monopoly illegally to stifle competition, and the rest is history.

After the earlier book was published, other judo examples started popping up. Yoffie learned, for instance, how Pepsi-Cola came back from the dead in the 1930s by using Coca-Cola Co.'s own power—its vaunted network of loyal bottlers—against it. Pepsi matched Coke's price but doubled the size of its bottles,

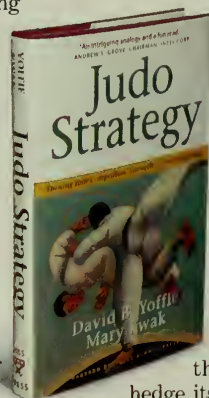
to 12 ounces. Coke couldn't match Pepsi's move because its bottlers were deeply invested in six-ounce bottles. It took Coke 22 years to respond, and then Pepsi was entrenched as the No. 1 player in the soft-drink market.

Some of the moves the authors highlight are subtler. Meg Whitman, CEO of Web auction leader eBay Inc., "gripped" online giant AOL judo-style and turned into a partner rather than a competitor when excitement about the potential for online auctions hit fever pitch in 1997. Recognizing that AOL would want a role, Whitman at first made a deal with AOL to create links from a handful of key AOL Web pages to eBay and ultimately arranged to make eBay the exclusive auction provider on all AOL properties.

Yoffie and Kwak focus on three updates to tell their tale. The early leaders of Palm Computing used a handful of judo moves to make their company the leader in handheld computers. One key: Unlike Netscape, Palm didn't confront Microsoft directly and thus avoided becoming a target for obliteration. The entrepreneurs who started CNET Networks Inc. bested the powers in the technology-magazine business: CNET dared them to cannibalize their own print publications with online publishing operations. In the end, the established players were unwilling to do what was necessary to win online. And RealNetworks Inc., the pioneer of streaming media on the Web, got rival Microsoft to hedge its bets and invest in Real—making it harder for the giant to decide to put Real out of business.

The fortunes of all three startups have declined in the past year because of the economic downturn, and, in some cases, strategic mistakes or new competitive threats. But the martial-arts metaphors keep working. In judo, the match isn't over when a small fighter throws an opponent over his shoulder. And it's the same in business. Just when a company decides the battle is over and it has won—that's when it's apt to find itself suddenly flat on its back staring at the sky.

BY STEVE HAMM
Associate Editor Hamm edits and writes on software and tech leaders.



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BY GARY S. BECKER

IT'S TIME TO GIVE UP THE WAR ON DRUGS



CONTROLS:
Legalization
should be
followed by
enacting
stiff laws
prohibiting
sales to
minors and
driving while
under the
influence

Gary S. Becker, the 1992 Nobel laureate, teaches at the University of Chicago and is a Fellow of the Hoover Institution.

The Bush Administration appears determined to continue the war on drugs that has been actively pursued by all U.S. governments since the Nixon Administration. I believe this is a serious mistake because that approach has failed badly. Legalizing marijuana, and even some hard drugs, may be a more effective alternative.

Defenders of the war on drugs often throw in an economic argument: It has been successful because it curtails use by raising street prices. It does this because suppliers have to be compensated for the risk of imprisonment and other punishments. It may be true that high prices have reduced the demand for drugs, but the fact remains that most illegal drugs remain popular and available, regardless of price. More important, any reduction in the number of addicts and other users has come with an enormous price tag. The U.S. alone spends almost \$40 billion annually fighting the drug war, and other countries also spend big sums.

The war is fought by seizing and destroying drugs and by apprehending and imprisoning suppliers. Large numbers of Americans were jailed on drug convictions during the 1980s and '90s, so that they now account for more than 30% of all inmates. A depressing fact is that the U.S. imprisons a larger fraction of its population for drug-related offenses than European nations do for all crimes.

The high prices due to the war have provided huge profits for cartels and others who evade detection and punishment. Estimates place the world market value of illegal drugs at several hundred billions of dollars—in the same league as the markets for cigarettes and alcohol.

STREET WAR. To protect their profits, criminals battle police and bribe officials all over the world. Some cartels have become more powerful than the governments that oppose them. The economy of Colombia, the world's biggest exporter of cocaine and a major producer of heroin, has been wrecked by the conflict between drug cartels and government efforts, financed by the U.S., to eradicate production of cocaine and heroin. These efforts have had only modest success.

Competing American gangs intimidate and assault, and sometimes murder, anyone who opposes them as they fight over the large illicit profits from drugs. This has helped devastate many inner-city neighborhoods because poor blacks and Hispanics in these neighborhoods are the main foot soldiers in drug supply networks. They earn what may appear to be pathetically little, given the risks they take, but their earn-

ings often are higher than what they could get in legal jobs. And there is also a small chance that they will make a big score.

Legalizing drugs is far from a panacea for the distress caused by drugs, but it will eliminate most of the profit and corruption from the drug trade. Ending Prohibition almost immediately cleaned up the liquor industry. To be sure, legalization will increase drug use by, among other things, lowering street prices, but that can be partially offset through sizable excise taxes on producers. In many nations, retail prices of cigarettes, alcohol, and gasoline are several hundred percent higher than their wholesale prices because of large "sin" taxes on them. The revenue collected from large taxes on drugs could be used to treat addicts and educate youngsters about the harmful effects of many drugs.

Although some drug production would go underground to avoid high taxes, experience with liquor, gasoline, and cigarettes shows that most producers would operate legally. They would want to use the courts in order to settle contract disputes, to raise funds on financial markets, and to avoid the penalties associated with criminal production. In addition, many consumers would prefer legal suppliers of drugs because they provide better control over quality and safety, considerations that are even more important for drugs than for cigarettes and gasoline.

Although legalization would make drugs cheaper and more readily available, sales to minors could be discouraged by harsh punishments achieved by restricting legal sales to designated shops. The present system has not been effective in discouraging drug experimentation by the young in part because suppliers are subject to punishments whether they sell to adults or children.

And anyone who drives or works while impaired by drugs should be subject to severe punishments because they are a menace to others. A good example to follow is the tough approach that some nations take toward drunk drivers: They lose their licenses, pay fines, and frequently receive stiff jail sentences.

Since legalizing drugs is a venture into the unknown, it may be wise to proceed in steps. But sooner or later, the human and other costs directly due to the continuing wars on drugs will force a new approach. So far, no one has devised a better alternative than legalization of drugs combined with a high "sin" tax on users, safeguards against sales to children, and severe punishments to anyone who drives or works while impaired by drugs.

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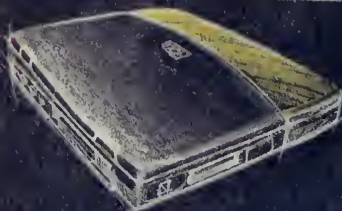
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PROJECT NAPOLEON (HP OMNIBOOK 6000)

DESIGN GOAL: MAX. PERFORMANCE/IN.³



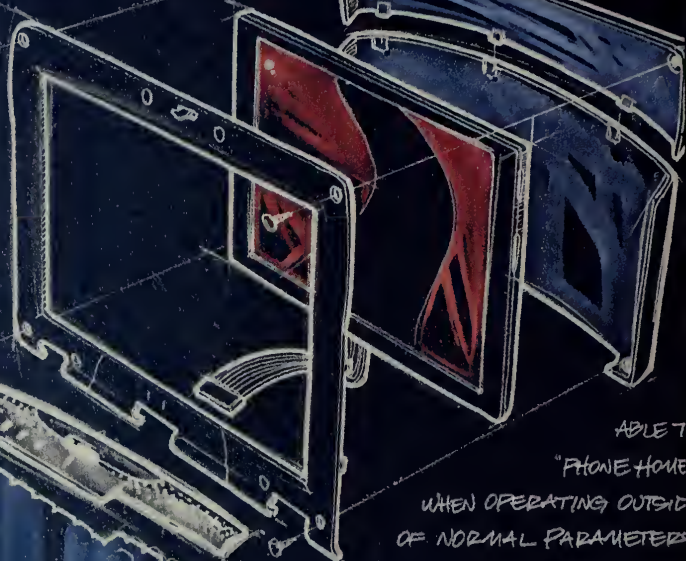
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BY GENE KORETZ

DOWNSIZED IN A DOWN ECONOMY

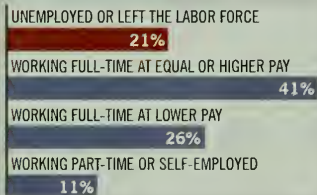
Can today's laid-off workers recover?

Ford Motor Co. says it will soon cut its payrolls by at least 4,000 to 5,000 white-collar workers. Agilent Technologies Inc. announces plans to eliminate 4,000 jobs. Gateway Inc. reports it is cutting its worldwide staff by 5,000. The drumbeat of layoffs by major corporations continues unabated.

Although restructuring and downsizing have become a permanent aspect of

WHAT HAS BEEN HAPPENING TO DISPLACED WORKERS?

STATUS IN EARLY 2000 OF FULL-TIMERS WHO LOST PERMANENT JOBS IN 1997-98



Data: Labor Dept.

U.S. corporate strategy, the current surge appears unprecedented. According to outplacement firm Challenger, Gray & Christmas Inc., planned job cuts unveiled so far this year already exceed 1.1 million, up 83% from last year's 12-month tally and far above any annual total in the past dozen years.

For economy watchers, the big fear is that continuing news of hefty job cuts will undermine consumer confidence, sparking spending cutbacks that will further imperil the already shaky 10-year expansion. But for the growing number of laid-off workers—especially those severed from long-term permanent jobs—the burning question is the impact on their own economic futures.

A hint is provided by the Labor Dept.'s latest biennial survey of workers who lost long-term jobs (held for at least three years) in 1997 and '98. Conducted early last year when the economy was still red hot, its results indicate that even in the best of times many displaced workers take a big hit.

To be sure, reemployed workers did significantly better than in earlier surveys, finding jobs faster, suffering smaller pay losses, and posting larger pay gains. But a year or two after being

laid off, over a fifth of former full-timers were either still unemployed or had left the labor force, and another 11% were either self-employed, working part-time, or doing unpaid family work.

Nearly 40% of reemployed workers had to change occupations to find work. Moreover, 39% of those back on full-time payrolls were receiving less pay than at their previous jobs, with more than half of these suffering nominal wage declines of at least 20%. (Adjusted for inflation, of course, the declines were larger.)

Worrisome as some may find it, the picture above is probably a best-case scenario, showing what happens to displaced workers in a dynamic high-tech economy when it is moving ahead on all cylinders. The fate of today's permanent job losers in a period of falling employment and plummeting profits will be far more onerous.

The outlook for displaced workers in their 50s and early 60s may be especially dicey. That's the age category that took the greatest economic lumps in the layoff surges of the early and mid-1990s. It's also the category many baby-boomers have recently entered.

WHY MARRIED MEN EARN MORE

A new study says it solves the puzzle

What explains the so-called marriage premium—the fact that married men tend to earn more than single men of similar backgrounds and educations? Economists have been divided on the issue.

Some believe that married men earn more because women tend to select mates with good earnings prospects. Others credit the institution of marriage itself, arguing either that it makes men more responsible and diligent or that it boosts their productivity by freeing them from housework and allowing them to focus more on their jobs.

In a new study in the journal *Economic Inquiry*, Hyunbae Chun, of Queens College in New York, and Injae Lee, of New York University, claim to solve the puzzle. Analyzing 1999 survey data covering nearly 2,700 men, they find that married men earn an average of 12.4% more per hour than never-married men, after adjusting for age, work experience, education, and other factors that may affect both wages and marriage prospects.

The two researchers find no evidence

that the marriage premium reflects the better economic prospects of men who tend to get hitched. Rather, it appears related to the state of being married—and specifically to the likelihood that wives shoulder household tasks.

Chun and Lee report that the wage gap declines as wives put in more hours working outside the home. While married men whose wives aren't employed earn about 31% more per hour than never-married men, for example, married to women with a full-time job earn only 3.4% more.

Thus, having a wife who devotes most of her time to raising the kids and other housework evidently pays off for dad in his work on the job. All of which implies that the marriage premium will inevitably shrink as more wives spend longer hours at outside jobs.

By Charles J. Whalen

GUESS WHO TAXES POLLUTION LEAST?

Making a mess costs less in the U.S.

Economists have long argued that an efficient way to control pollution is to make those who cause it bear some of the costs via environmentally related or "green" taxes. These can range from retail taxes on gasoline to landfill charges on waste disposal.

By dint of its economic heft, the U.S. is commonly regarded as the world's biggest polluter. Yet the Organization for Economic Cooperation and Development reports that it imposes the lowest green taxes as a percent of gross domestic product of any industrial nation. While the average for OECD countries in 1998 was 2.7% of GDP, for example, the U.S. level was estimated at less than 1%.

Between 1994 and 1998, a majority of OECD members boosted their green-tax ratios, with Denmark's and Turkey's both rising by a full percentage point to 5% and 3% respectively. By contrast, the U.S., Germany, and France actually reduced their green-tax levels over the four-year period.

GREEN TAXES BY THE NUMBERS

ENVIRONMENTALLY RELATED TAXES AS A SHARE OF GDP*



BY JAMES C. COOPER & KATHLEEN MADIGAN

CAN IT BE THAT THE WORST IS OVER?

Firmer manufacturing stats offer hope, despite the tech morass

U.S. ECONOMY

If you're looking for concrete signs that the economy is getting back on its feet, check out the recent encouraging reports from the manufacturing sector. The factory recession, which began last autumn, has been a huge drag on economic growth. Now, manufacturing is starting to firm up, and that's a big plus for the outlook.

Analyzing the factory data, however, requires care. Makers of tech equipment show no improvement at all, with little hope for a turnaround anytime soon. Tech orders and output are still falling, and inventories remain way out of balance with demand.

Despite tech's heavily skewed impact on the overall data, though, the other 90%

U.S. manufacturing is finding firmer footing. In particular, the August report from the nation's purchasing managers, which shows improvement in industrial activity, corroborates recent government data showing that output and demand are stabilizing, and that inventory excesses are shrinking.

At the same time, overall demand in the third quarter is holding up. The problem is that spending is still proceeding down two different tracks: Consumer buying continues to grow at a moderate clip, while business investment, especially in tech equipment, is declining. That's why the tech sector of manufacturing is weighing so heavily on overall industrial activity.

THE MOST UPBEAT NEWS from manufacturing comes from the National Association of Purchasing Management's August survey. The purchasing managers' index—a composite of orders, output, employment, inventories, and delivery speeds—posted a surprisingly strong increase, to 47.9%, up from 43.6% in July (chart). The monthly gain was the largest in five years, and the level was the highest since last November.

The index remained below the crucial 50% mark, which is the dividing line between recession and expansion in the factory sector, but two key component indexes—orders and production—popped over the 50% line. The purchasers are saying that both demand and output actually increased for the first time since last year. Indeed, the forward-looking orders index in

August rose to its highest level since April, 2000.

The NAPM report is the best sign yet that the worst of the slowdown has passed. The trade group says that the August level, if maintained, is consistent with 1.9% growth in real gross domestic product. The stock market, with its mind-set that good news on the economy is good news for future profits, soared on the NAPM's news on Sept. 4, but it fell back later in the day as investors registered thumbs down over the proposed Hewlett-Packard-Compaq merger (page 40).

The report also suggests that manufacturers have made great strides in eliminating their excess inventories. The 13% of purchasers saying their customers' inventories are "too high" remains far below the January peak of 26%. And for the third month in a row, more purchasers said that inventory levels were "too low" than "too high." That's a good sign for ordering and output in coming months.

The latest government data on manufacturing orders, which runs through July, also offers some hope. Despite a 0.7% drop in durable-goods orders in July, total orders edged up 0.1%, thanks to strong gains in bookings in nondurables and consumer goods (chart). The weak spot: capital equipment, where nondefense, nonaircraft orders fell for the sixth month in a row.

THE DRAG ON ORDERS coming from the tech sector has been enormous. Tech bookings are only about 10% of overall orders, but during the past year, they have accounted for about half of the 7.3% drop in factory orders. Since January, total factory orders are down 1.1%, but excluding tech bookings, they are up 1.4%.

The skew from the tech sector is also evident in the inventory data. The overall ratio of inventories to sales in manufacturing in July was not much lower than it was at the beginning of the year. But excluding tech manufacturers, the ratio has declined noticeably in recent months.

The reason for the tech inventory problem is that manufacturers aren't cutting their stockpiles fast enough. Since January, tech inventories have shrunk by 6.8%, but shipments have plunged 19.3%. The inventory overhang is not a good sign for stronger output

PURCHASERS SEE SIGNS OF IMPROVEMENT



WHERE FACTORY ORDERS ARE PICKING UP



anytime soon. The tech wreck will hamper economic growth for months to come, but the latest factory data imply that tech alone will not prevent at least a modest recovery from taking root.

EVEN SO, an upturn will depend on consumers who, so far, are willing to keep the economy afloat. Indeed, while capital-goods orders are down 15% since January, bookings for consumer goods, which are twice the size of capital goods, are up slightly. Equally important, consumer buying should soon get a powerful boost from Washington.

In July, price-adjusted household buying rose 0.2%. If buying continued at that pace for August and September, then real consumer spending would grow at an annual rate of 2.5% this quarter, the same advance posted in the second quarter. That pace, while modest, was still large enough to more than offset the drag on second-quarter growth from the plunge in business spending on capital equipment.

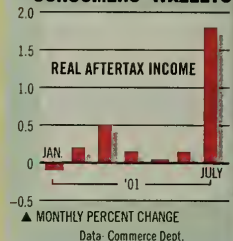
Spending could pick up, however, because incomes are getting a boost from the tax rebate and tax cut. Aftertax income jumped 1.7%, or \$128 billion, from June to July (chart). The Commerce Dept. said that \$95.1 billion of the gain was the result of rebate checks and the reduction in tax withholdings. Since the tax checks only began hitting consumers' mailboxes on July 20, the income gain in August will be even greater.

Plus, capital gains remain a source for spending. In speech at the Federal Reserve's annual symposium in Jackson Hole, Wyo., Chairman Alan Greenspan said that wealth from all sources "appears to explain one-fifth of the total level of consumer outlays."

Rising home prices have generated a big chunk of that wealth. When a house is sold, Greenspan said that 10% to 15% of the capital gain goes to new consumer spending. He also said "a considerable amount of cash is extracted" from refinancings and home-equity loans. And refs remain quite popular, thanks to mortgage rates below 7%. In August, mortgage applications for refs were up by large 32.5% from their July average.

Clearly, the economy is caught between the downward forces of the tech meltdown and the upward pull of a steadfast consumer sector. That tug of war means any recovery in the manufacturing sector will be painfully slow. But thanks to the lift from Washington and a resilient housing market, consumers now have the upper hand. And chances are improving that factories—and the overall economy—will be a lot healthier by early next year.

MORE GREEN FOR CONSUMERS' WALLETS



THE EURO ZONE

FINALLY, A BIT OF RATE RELIEF

Investors to the European Central Bank: It's about time.

The ECB finally cut short-term interest rates by a quarter point on Aug. 30. Although the move was expected, ECB watchers were getting impatient because the cut lagged behind weeks of data showing that the euro zone economies were slowing sharply. Some lowlights: Germany's economy did not grow in the second quarter. Consumer confidence in the Netherlands fell to a five-year low in August. And the number of unemployed in France jumped by 57,000 in July, the biggest advance in five years.

Despite the dim euro zone outlook, the ECB was reticent about

cutting rates because the bank's legal mandate is to fight inflation. Indeed, policymakers seemed to go out of their way to remind investors that the bank's purpose is not to promote economic growth.

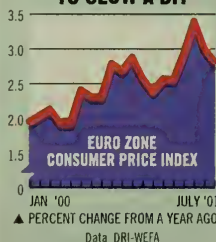
Bundesbank President Ernst Welteke said: "The ability to fine-tune growth is clearly overestimated." And ECB member Klaus Liebscher told Reuters newswire that policy "is not a panacea to boost growth."

Policymakers' reluctance can be traced to the recent runup in consumer prices. Yearly inflation for the entire euro zone stood at 2.8% in July. But while that's above the ECB's 2001 target rate of 2%, the pace is an im-

provement from May's peak of 3.4% (chart). Moreover, the inflation outlook is quite sanguine. A large chunk of the acceleration was caused by higher energy prices, which have since receded. And the euro has strengthened, so prices for imports should come down. Since July, the euro is up 5% against the U.S. dollar.

Whereas the euro zone grew by a strong 3.4% in 2000, expectations are that growth has slowed to between 2% and 2.5% this year. But the ECB's statement suggested policymakers are in no rush to reduce rates again anytime soon. Analysts expect one more trim before the end of this year. That would make it only the third cut this year—far behind the seven rate reductions by the Federal Reserve and the four by the Bank of England.

INFLATION BEGINS TO SLOW A BIT





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WHERE'S THE UPSIDE?

HP-Compaq will lead in PCs—but not in costs or technology

On Sept. 5, a standing-room-only crowd of investors at Boston's Copley Marriott hotel listened to Hewlett-Packard Co. CEO Carly Fiorina and Compaq Computer Corp. chief Michael D. Capellas explain HP's blockbuster \$25 billion deal to buy its long-time rival. When they left the stage 30 minutes later, the applause was barely audible. "They are two pathetic companies just trying to survive," said Sanjay Jhaveri, a technology analyst at Zurich-based Vontobel Asset Management, shaking his head. "Their backs are against the wall."

Boy, are they ever. Fiorina's record-setting purchase, by far the biggest in computer-industry history, is supposed to create a high-tech powerhouse capable of taking on everyone from scrappy Dell Computer Corp. to mighty IBM Corp. Armed with the market-share lead in PCs, back-office servers, and printers, the new HP would have the sheer bulk and reach to turn these two troubled companies into one far healthier one. But investors don't see it that way. Shares of both companies collapsed after the Labor Day announcement. With HP shares plummeting 21.5% and Compaq tanking 15.7%, together the pair lost \$13 billion in market capitalization in just two days, raising questions of whether

the deal can proceed. "It's like taking two stones and tying them together to see if they float," says one large institutional investor.

Fiorina insists the market is overacting. "People are surprised.... Clearly, we still have a lot of educating to do," she told *BusinessWeek*.

But gleeful rivals are portraying HP not as a new juggernaut on the rise but as a wounded behemoth. "When two sick companies combine, I'm not sure what you get," Sun Microsystems Inc. President Edward J. Zander told investors on Sept. 5. "This is a great opportunity for us, IBM, and others to go after market share."

The critics could be right. While there's plenty of potential, this deal is beset by mind-numbing problems. If the deal goes through, the merged company will have a 19% share, making Fiorina the global PC Queen—just as the PC industry is dealing with a worst-ever downturn that has resulted in \$1.2 billion in losses and 31,000 layoffs so far this year. And while the deal is designed to lift Compaq and HP from also-rans to



HOW AN HP-COMPAQ COMBO WOULD MEASURE UP



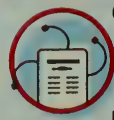
PCs

With 19% market share, it would be the world's largest PC maker. But with PC sales and margins at record lows, the companies have lost a total of nearly \$500 million this year, while Dell continues to gain.



PRINTERS

HP's dominant 50% market share would grow, as would sales of its hugely profitable printer ink. But margins and sales are weak, and pricing pressure is mounting from Lexmark, Canon, and other rivals.



LOW-END SERVERS

Compaq dominates and the combined companies would have a huge market share. Windows-based machine cutthroat competition from Dell and IBM could eat at sales.



leaders in cushier markets such as high-end servers and consulting, just combining revenue streams won't provide the technology or top talent to get the job done. Plus, the odds of pulling off a successful mega-merger are against HP: Historically, such deals in the computer industry have bombed badly even in bright economic times. And the prospect of another bungled tech merger has hungry rivals licking their chops. "Our sales guys' eyes are

costs to the bone to beat Dell in PCs while pouring money into research and development and consulting to take on IBM and others on the high end. Since more than half the new company's sales would be from low-margin PCs and printers, analysts wonder where those R&D dollars will come from. Indeed, rather than build up its R&D kitty, both Compaq and HP are moving away from proprietary high-end computers to focus on models based on Intel chips.

A LEAP. There's also no guarantee that the combo will result in the services powerhouse Fiorina is banking on. The deal would make HP the No.3 player behind IBM and EDS, with an impressive \$15 billion in annual sales. But while Fiorina's aborted \$16 billion bid for PricewaterhouseCoopers last fall would have brought in a full stable of top-notch consultants, Compaq brings mostly lower-paid computer-repair people. While Compaq boasted a big services win when it landed a \$100 million contract with Sabre Inc., the travel-reservation giant is relying on EDS for the more profitable consulting and outsourcing services.

Given all the obstacles, Fiorina and Capellas are taking a huge leap. They insist the risks are manageable. Regardless of the turmoil in the tech market, they say, HP-Compaq will be perfectly positioned when corporations start spending again. More focused rivals, such as IBM, Sun, and EMC have dominated the most profitable niches, they add, but customers tired of bubble-era tech promises will cotton to the new company's soup-to-nuts approach. And by slashing costs to stem losses in the near term, Fiorina and Capellas are betting on growing with the industry at 10% a year, handily beating even IBM's 5% clip in recent years. "There's a huge opportunity for stronger growth and more stable growth," says Fiorina. "But this is a lot of news. It takes people time to digest it."

Wishful thinking? Fiorina and Capellas do have a lot to work with. The deal, which they hope to close by next sum-

lighting up," says Sun's chief marketing officer, John Loiacono. Adds Dell CEO Michael S. Dell: "If [this] is anything like other [industry] mergers we have seen, they are very hard to make work and can create significant distractions while we will be delivering great value to our customers."

Indeed, the deal could leave HP in a dangerous no-man's land. The company must cut

HIGH-END SERVERS

In this key high-margin market, HP and Compaq are laggards. Compaq will out its Alpha servers, HP's high-end UNIX lines have stagnated at Sun and IBM.

SERVICES



HP and Compaq covet IBM's services business. But 62% of their 65,000 service specialists do basic computer repair, not the lucrative high-end consulting Big Blue specializes in.

STORAGE



Compaq's \$5.2 billion storage business should get a big boost as HP sells Compaq gear to its customers. Still the merger wouldn't help HP take customers from storage giant EMC and others.

SOFTWARE



Providing soup-to-nuts solutions for big corporations requires specialized software called middleware. But HP badly lags rivals, and Compaq is a no-show.

mer, would create a giant with revenues of \$87 billion this year. That's just a smidgen smaller than IBM. It will dominate huge swaths of the tech landscape, not just PCs but also printers, where HP owns a more than 50% share and runs a hugely profitable printer-ink business. It will have a broader reach than any other tech company, from retail stores that sell to consumers to sophisticated back-office gear. "Combining their hardware skills and service efforts gets them much closer to critical mass across the board," says Intel Corp. CEO Craig R. Barrett. "It would seem to me to make a whole lot of sense."

The idea is simple enough: First, fall back on the cost efficiencies that come with sheer bulk, then concentrate on gaining momentum on the higher-growth, high-margin sectors. By combining operations, Fiorina expects to emerge with a far more efficient compa-

ny able to churn out profits thanks to volume. HP estimates it can save \$2.5 billion a year starting in 2004, largely by cutting 15,000 jobs. And it will exploit its market power for everything from better deals with suppliers to pressuring software developers such as Oracle Corp. and SAP to push HP gear. Then, over time, it will develop the consulting and software smarts to help customers deliver whizzy new offerings. "Today is about changing the game—not only for our two companies but about changing the industry itself," says Fiorina.

The proposed deal is winning praise from HP's allies. Besides Intel's Barrett, Oracle CEO Lawrence J. Ellison is a fan. "This will be the biggest hardware company in the world, and that gives them tremendous market power," says Ellison, who dismisses Wall Street's chilly response. "Keep in mind, the [stock] market is the one that said Ariba Inc.

was more valuable than Daimler Benz. That's the market for you."

All true. But Fiorina and Capella still face a mind-numbing merger that will involve integrating scads of overlapping product lines and 150,000 people in 160 countries. HP has never done an acquisition anywhere near this big. And many of Compaq's problems stem from its 1998 purchase of Digital Equipment, which itself was billed as a vehicle to transform Compaq from a mere purveyor of hardware to a soup-to-nuts tech services provider to take on IBM. What's more, both companies have struggled to absorb sweeping reorganizations in their own right. Many HP insiders feel Fiorina should have backed away from the PC business and other trouble spots rather than add to HP's complex structure.

But that's hardly an option for Fiorina. HP is more reliant on its core PC and printer sales than ever. With 42% of

MAKING THE CASE FOR COMBINING

The proposed merger of Hewlett-Packard Co. and Compaq Computer Corp. was panned by a skeptical Wall Street after it was announced on Sept. 3. Now Carly Fiorina, chairman and chief executive of HP, and Michael Capellas, chairman and CEO of Compaq, have a big sales job ahead of them. On Sept. 5, they spoke with BusinessWeek Associate Editor Steve Hamm and Computer Department Editor Peter Burrows to make their case.

The stock market didn't greet this merger very well. You got beat up pretty badly. Is it possible that could kill the deal?

Fiorina: No. This is a very tight agreement. You don't make this kind of move and judge its success by the short-term stock price.

How are you trying to sell this merger to investors?

Fiorina: Initially people hear a cost-reduction story. And there's certainly a huge opportunity for value creation in the relatively short term. But we need to continue to accentuate that there's huge opportunity for stronger growth and more stable growth. This is a lot of news. It takes people time to digest it.

What's your vision for how the combined company will look? Will it be a growth company like Dell or an earnings company like IBM?

Capellas: With a company of this size, you won't have the growth rate of a smaller company, but you'll also have steady earnings growth with less variability.

Fiorina: Look at the revenue balance of the combined company. If all it does is grow at market, and you're talking about 10%, that's nothing to sneeze at for an \$87 billion company. But you also

fastest. The customer service side is growing slower but is very profitable.

After a merger, you'd still be up

“You don't make this kind of move, and judge its success, by the short-term stock price” —CARLY FIORINA

get \$1 billion a quarter of free cash flow. That's pretty impressive.

What do you see as the real growth engines of the company?

Capellas: First and foremost you've got services growth, the fastest-growing segment of the whole IT market. Managed services and outsourcing is growing

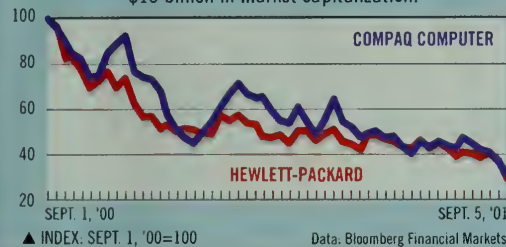


p's growth coming from PCs in 2000, there was no backing out now. And while PC sales help the top line, profits from the printer-applies unit held up the bottom line. The \$7 billion operation, which makes printer ink and paper, brought in all of HP's \$469 million in profits for the past two quarters, according to analysts. Fiorina's plan had been to let the high-end computing business—servers, storage, software, and services—do the heavy lifting in 2001. But the economic downturn and poor execution, including product delays and reorganization-related confusion, quashed that.

And while the merger gives HP gigantic market share in many areas, that share is shrinking in many key areas. Although it enjoys the biggest share of the PC market now, the combined company's share is expected to remain flat, while Dell grows 30% a year. HP's 35% share in servers is down

MERGER BLUES

After a year of declines, both HP and Compaq shares plummeted in the wake of the proposed deal, slicing off combined \$13 billion in market capitalization.



from 39% in 1999, according to Gartner Dataquest analyst Martin Reynolds. And while HP should benefit from Compaq's surging storage business, other areas of big share gains are few. Mostly, it could gain in nascent markets such as handhelds, where Compaq's iPaq is a hit, or in markets where it has a small presence.

Still, Fiorina is convinced she's on the

right track. "I wouldn't do this if I thought it would be a detour," she says. "I only do it because I think it will accelerate our progress." She admits the challenges are great, and there are holes in the strategy. Once the merger is moving smoothly, by next year, she says she'll look at more acquisitions to pump up that services capability. But not now. "We can't bite off more than we can chew," she says. And if she already has? Given the sweeping internal problems each inherited from predecessors

and the economic downdraft they've since run into, it's likely neither Fiorina nor Capellas could have achieved their respective grand ambitions on their own. Then again, it's not at all clear they'll be able to do it together, either.

By Peter Burrows in San Mateo, Calif., and Andrew Park in Dallas, with Steve Hamm and Geoffrey Smith in Boston, and bureau reports

companies that are more focused on doing one thing well. So how can this deal help you compete with them?

Capellas: Customers want simplification. They want fewer partners to deal with. And they want the partner to do

more of the integration. We believe we can be brutally competitive in the individual product segments. But we can also integrate hardware and software into solutions.

Where are you taking services?

Fiorina: We'll continue to organically grow, particularly the outsourcing and consulting ends of the business. We'll be looking for strategic opportunities for acquisition. Also, consulting companies know they need a partner with the engineering capability to build the technical infrastructure. Who are they going to call? Are they going to call Dell? Hell no. There's one company they're going to call. It's this company.

Why are you staying in consumer PCs?

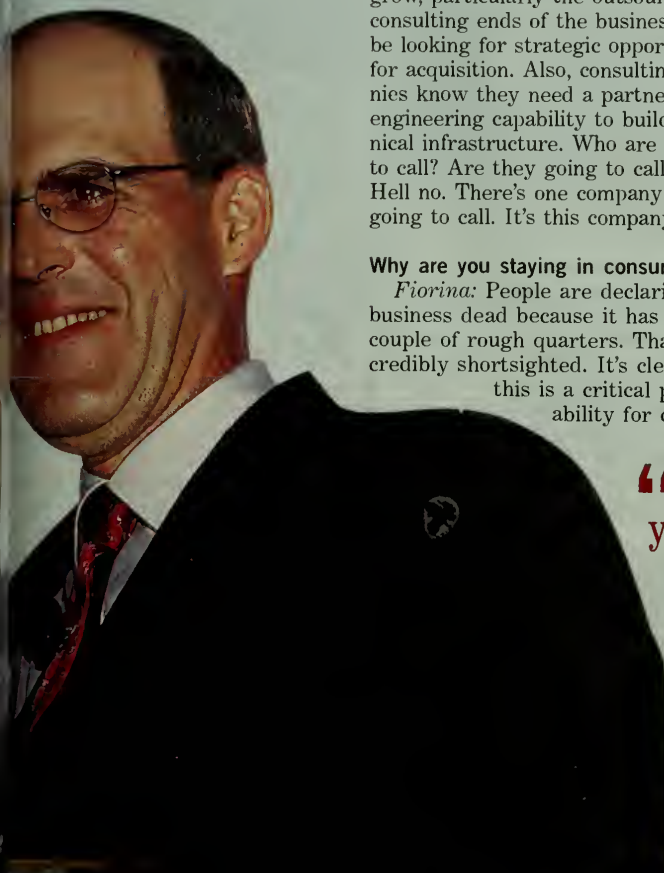
Fiorina: People are declaring the PC business dead because it has had a couple of rough quarters. That's incredibly shortsighted. It's clear that this is a critical part of the ability for consumers

to do interesting things in their homes. But the reason for buying isn't going to be to get the hottest box at the lowest price. You've got things like digital imaging, digital music. It's something that does something for a consumer. This is what the industry is missing. It's innovation. That's what Dell can't do.

Can you ever be as efficient as Dell in the PC business?

Capellas: There is very clearly a balance between innovation and being first to market on one hand, and pure, raw, low cost on the other hand. If you don't spend any money in R&D you will by definition have a couple of points on the bottom line, but you'll also never lead in any new product categories, so you won't get the margins there. Look at handhelds. They generate incredible margins because there's innovation the customer is willing to pay for. A model that puts nothing into innovation is not sustainable over time.

“With a company of this size, you won't have the growth rate of a smaller company, but you'll also have steady earnings growth with less variability”—MICHAEL CAPELLAS





COMPUTERS

SOFTWARE FACES A HARD LANDING

It may not be spared tech's trauma for much longer

Looks like it's finally the software industry's turn. While big computer hardware manufacturers like Cisco Systems Inc. were battered in the first half of the year, many of their brethren in the software industry emerged relatively unscathed. Sure, there were high-profile flameouts like Ariba Inc. But annualized business spending on software in the first half of 2001 was off only 5% from the same period last year, according to a Morgan Stanley Dean Witter & Co. analysis of Commerce Dept. data. Compare that with the staggering 31% decline the rest of the information-technology industry suffered.

Now, however, the outlook for software is suddenly looking a lot more grim—and many economists and Wall Street analysts who follow the industry say it's unlikely to improve anytime soon. Stephen S. Roach, chief economist at Morgan Stanley, now figures that software orders could fall another 10%-20% over the next year. "We've seen a collapse in IT spending, particularly in hardware," says Roach. "I believe software will be the next to go."

Indeed, if history repeats itself, Roach's worst fears could come true. In past downturns, software spending declines usually trail the rest of the technology industry by six to nine months.

That was the case in the last major tech slump in 1990-1991 and again in the mid-1990s—meaning the time for the software spending tap to shut is just about now. Indeed, with software accounting for 43.6% of all IT spending today—the highest level ever—companies that need to further trim tech budgets may have nowhere else to turn.

Beyond the weak economy, the industry can blame some of its earlier excesses as well. Once-booming sales of Net software for things like business-to-business exchanges have all but collapsed, as companies got only limited value from earlier purchases. And forget sales of online retailing software. "I've always said the dot-com shakeout wasn't over until the B2B shakeout was over," says William T. Coleman, CEO of BEA Systems Inc.

Another big problem is the buying outlook for more traditional industries. They have become huge software customers, but there, too, big cutbacks could be coming. General Motors Corp., for example, is whacking

\$100 million a year from its \$3 billion budget. So far, it hasn't cut from the \$500 million analysts estimate it spent on software. But slowing auto sales could bring a rethink. "We're going to have to look at where the economy and its effects on the industry in the next year," says Ralph Szygenda, GM chief information officer.

Moreover, much of the \$200 billion companies expect to spend this year on software will go to purchases of Microsoft Corp.'s new Windows XP operating system. That could come at the expense of big and costly companywide software systems. "No one is buying anything," says analyst Melissa Eisenstat of CIBC World Markets.

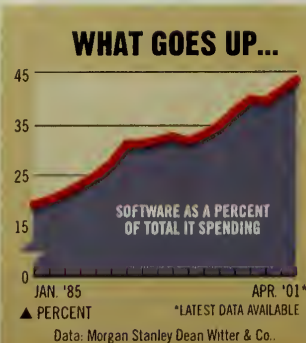
BREAD AND BUTTER. That may be an exaggeration. But companies like Ariba and Commerce One Inc., which specialize in B2B software, aren't likely to see their suffering end anytime soon. And companies like BroadVision Inc. and Aptiv Technology Group Inc., whose bread and butter was online retailing, look even more precarious. Even executives at companies like Siebel Systems Inc. and BEA, which blew through the first half of the year with 60% growth, say the rest of the year is going to be flat.

Little wonder, then, that Wall Street is increasingly pessimistic. Stocks for the sector as a whole are down more than 60% for the year—and they've dropped an additional 5% in just the last week. Given the weakening prospects, some believe they may still be overvalued. Says Bob Austrian, an analyst at BancAmerica Securities: "There's more room for some of them to come down."

When database giant Oracle Corp. reports its earnings on Sept. 13, the entire industry will be holding its breath. Back in March, Oracle was the first big software outfit to miss Wall Street expectations. Analysts now expect sales for its first fiscal quarter ended April 31 to fall about 5% from last year. Oracle could still surprise—but don't count on it. "Oracle has a history of kicking up

the band to get people excited," says Bob Sutherland, an analyst at Technology Business Research Inc. "They were expecting a strong quarter, you would have heard about it." For now, the tubas remain in the closet.

By Jim Kerstetter in San Mateo, Calif.
with David Welch in Detroit





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HEALTH CARE

AMERICA, THIS IS REALLY GONNA HURT

As profits drop, workers will get hit with higher health costs

If Tom Lerche or anyone else in his family falls seriously ill this year, he'll be paying a lot more of the bill. Under a new medical plan, his employer, Aon Consulting Corp., is providing up to \$2,500 for routine doctor visits and medicine. But after that, he has to pay every dollar until company coverage kicks in again at \$5,000. The company "is trying to get employees to behave as if they're spending their own money," says Lerche, a senior vice-president. People who reach into their own wallets, he says, "may be more cautious and conservative. They're more likely to consider a generic drug or ask a provider more about fees."

Or reach for the Prozac. After years of staying fairly flat, medical bills are climbing sharply again for Corporate America—and hard-pressed companies increasingly are passing more of the tab to their workers. Having already hiked insurance premiums a steep 11% this year, insurers are asking companies for increases of 18% or more in bargaining now under way to set charges for 2002 medical plans. While analysts expect that the final increase for companies will likely be closer to 13% to 16%, there's little doubt big annual price hikes are again becoming the norm. "We haven't seen these kind of increases since the early 1990s," says Kenneth Sperling, health-care practice leader for Hewitt Associates, an employee-benefits consulting firm. "Employers are struggling."

MAJOR SHIFT. Indeed, many are searching for new ways to contain those fees. They may have little choice. The weak economy has already left most employers wrestling with plummeting profits and desperate to hack costs. Few can swallow a big increase in health-care costs now. And the impact of increased costs could go well beyond the direct hit to individual pocketbooks and corporate budgets. "This is going to become a brake on economic growth and a major contributor to inflation," warns Sung Won Sohn, chief economist at Wells Fargo Bank.

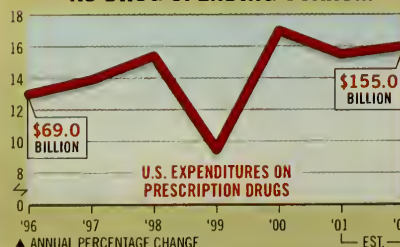
It all makes for a big shift from recent years. Employers who had gotten used to absorbing modest bumps in annual claims and premium costs are seeing increases across the board. The cost of popular point-of-service managed-care plans, which give employees a broad choice of doctors, jumped 14.1% between July, 2000, and July, 2001, reports Segal Co., a New York-based benefits consultant. Claims for health-maintenance organizations jumped 11.2%, while more traditional fee-for-service claims rose 11.9%. "The prospects are quite ominous," says J. George Mikelsons, chairman of American Trans Air, an 8,500-employee Indianapolis-based regional airline. "We'd be tickled pink if we could hold the increase to the high single-digit level."

Why the uptick now? For one, the big gains in fighting medical cost hikes are largely history for employers. In the early 1990s, they switched many staffers over from traditional fee-for-service indemnity plans to managed care and enjoyed big savings. But now, with all but perhaps 10% to 15% of employees covered by such plans, the one-time gains are behind them. "It was a fantasy to believe that managed care would solve the health-care cost problem," says Drew E. Altman, president of the Hen-

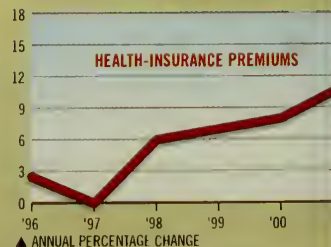


The Big Headache

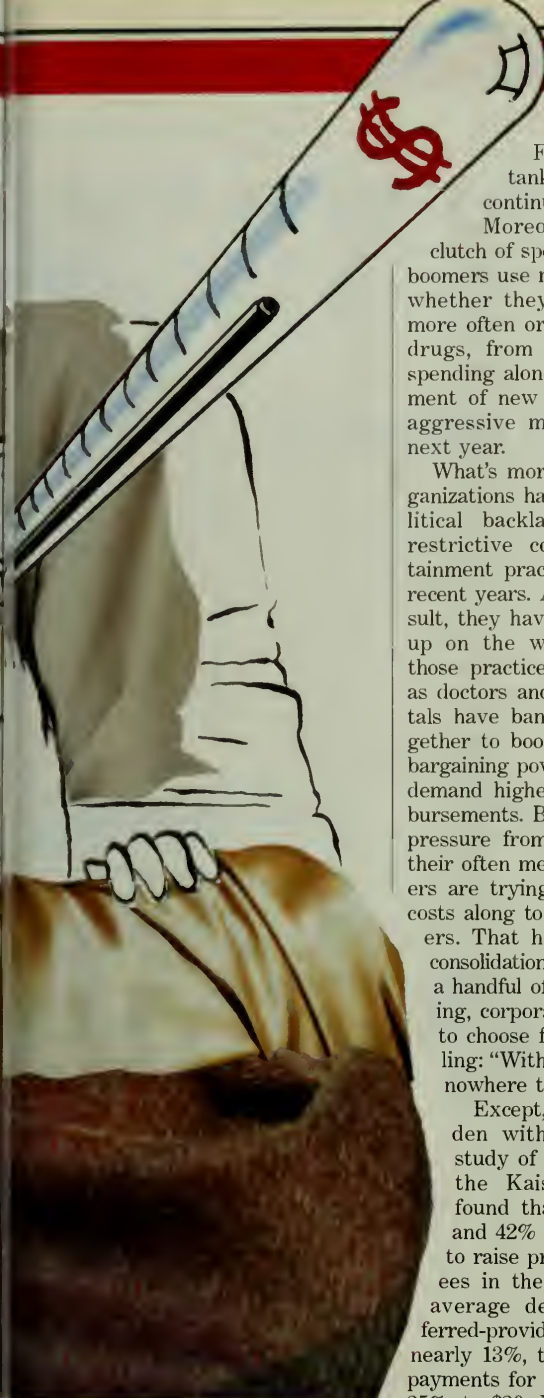
AS DRUG SPENDING SOARS...



...PREMIUMS SURGE...



Data: Bureau of Labor Statistics, Economy.com, Health Care Financing Administration, Kaiser Family Foundation, William M. Mercer Inc.



ry J. Kaiser Family Foundation, a medical think tank. "Health-care costs will continue to rise."

Moreover, experts blame a clutch of specific culprits. Aging baby boomers use more health-care services, whether they're going to the doctor more often or snapping up pricier new drugs, from Viagra to Vioxx. Drug spending alone, driven by the development of new medicines and evermore aggressive marketing, may rise 16% next year.

What's more, health-maintenance organizations have been stung by the political backlash against their most restrictive cost-containment practices in recent years. As a result, they have eased up on the worst of those practices, even as doctors and hospitals have banded together to boost their bargaining power and demand higher reimbursements. But with pressure from Wall Street to improve their often meager profits, health insurers are trying to pass those increased costs along to corporate insurance buyers. That has been made easier by consolidation in the industry: With only a handful of mega-insurers left standing, corporations have fewer options to choose from. Says Hewitt's Sperling: "With today's market, there's nowhere to go."

Except, that is, to share the burden with employees. A Sept. 6 study of some 2,734 employers by the Kaiser Family Foundation found that 75% of big companies and 42% of smaller ones are likely to raise premiums for their employees in the next year. Already, the average deductible for some preferred-provider organizations has risen nearly 13%, to \$407, this year and co-payments for drugs on average climbed 25%, to \$20. Many employers, too, are creating three tiers of drug copayments—they charge the least for generics, higher amounts for branded drugs, and still more for drugs that aren't on health plans' preferred lists. "They will not just ask workers to pay more," says the Kaiser Foundation's Altman. "They will tighten up in lots of little ways."

Some aren't so little. At Chicago-based Bank One Corp., for instance, higher-paid workers this year began paying a bigger share than their co-workers. An executive vice-president

now pays just over \$144 every two weeks for his point-of-service coverage, while staffers making under \$50,000 a year pay \$82.50 every two weeks for the same coverage. Last year, they all paid the same \$71.20.

Other companies are looking elsewhere to cover costs. That's the case at Microsemi Corp., a \$250 million-a-year semiconductor maker based in Irvine, Calif. Last November, to cut in half the 18% price hike sought by Microsemi's insurer, staffers began paying \$5 to \$10 more for each covered drug prescription, and most are also now paying more medical expenses out of pretax flexible spending accounts.

Small companies have been especially hard hit. CTC Communications Group Inc., a telecommunications equipment maker in Waltham, Mass., had to stomach an 18% rise in health-insurance costs in July. So now individual employees

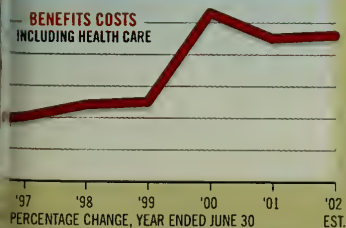
are paying \$75 a month more—a \$15 uptick—while families have seen premiums rise \$20, to \$150. "We absorbed increases the past five years," says human resources director Sandi Crespi. "We try not to pass on [costs] to employees, but this year we did."

SELF-INSURED. For some employers, dramatic change could be in the works. More and more companies are looking into so-called defined-contribution plans, such as the one Aon executive Lerche uses. Such plans cap the amount of money a company will shell out in health insurance premiums and shift more of the responsibility for containing costs onto the employee. And some employers, such as Apache Corp., a Houston-based oil and gas exploration company, are switching to self-insurance. Under such plans, insurers simply manage the billing but the companies themselves are responsible for actual medical costs. Apache is betting that it will be able to handle higher medical bills more readily than higher premiums and fees.

Ultimately, the cost hikes are forcing some employers to rethink how much they should spend on health care, if anything at all. Just 34% of large companies surveyed in the Kaiser Foundation study now offer health-care benefits to retirees, for instance. That's down from 37% last year, 41% in 1999, and 66% in 1988. Worse, many companies may be tempted to quit offering health-care benefits even to current em-

Already, many drug co-payments have climbed an average 25%, to \$20, this year

DO COMPANIES FEEL THE PAIN



ployees: With such benefits easily equal to 15% of the salary of an employee, only 65% of those companies surveyed by the Kaiser Foundation now offer health-care coverage. That's off from 67% last year.

Until recently, a combination of tight labor markets, strong profits, and the relatively modest increases in health-

care premiums in past years had allowed many employers to ignore such concerns. No longer. At Google Inc., the online search engine firm based in Mountain View, Calif., Chief Executive Officer and Chairman Eric E. Schmidt has been focused on the Internet meltdown, not medical bills. "I'll have to add that to the list of things for me to

worry about," he says. Considering the size of the coming price hikes, Schmidt and his fellow CEOs may find that controlling health-care costs hasn't simply been added to the to-do lists. It may quickly rise to the top.

By Joseph Weber, with Michael Arndt, in Chicago, Laura Cohn in Washington, and bureau reports

HOMEOWNERS, BRACE YOURSELVES

If you think health insurers are the only ones hiking prices, you're in for a surprise. Providers of homeowners' insurance are also having a tempestuous year—and homeowners are about to pay for it. After tepid increases of 2% or less over the past two years, home-insurance premiums in many states have surged 10% so far this year, and bigger hikes could be on the way.

What's going on? A wave of huge storms—including the vicious Tropical Storm Allison in June—have increased claims and destroyed insurers' profits. Making matters worse, losses in stock and bond markets have shrunk returns in many insurers' investment portfolios. "The quarter was a particularly trying one for Allstate, as we experienced the highest level of quarterly catastrophe losses since the Northridge [Calif.] earthquake of 1994," says Edward M. Liddy, CEO of insurance giant Allstate Corp. Its profits plummeted 63% in the second quarter—about the same dismal performance most insurers turned in.

BAD TIMING. These aren't pretty times for hard-pressed property and casualty insurers, most of whom also sell auto insurance. Home insurance, which generates roughly 10% of their business, has long been a loss leader. "In the past 10 years, insurers have lost 16¢ on every dollar spent on homeowners' policies," says Todd R. Bault, analyst at Sanford C. Bernstein & Co. While insurers traditionally made up for those losses by selling consumers more profitable auto policies, increased competition has

strained that sector lately, too. Under pressure from Wall Street—which has sent insurers' stocks tumbling 7% since the beginning of the year—many are trying to bolster profitability in home insurance.

The spate of bad weather, however, has meant that the push for profitability could not have come at a worse time. Catastrophic losses for home insurers in the second quarter alone totaled \$5.9 billion, exceeding

yearend because of a sudden jump in mold-related claims, which have worsened with flooding from the storms. The average insurance payout for a mold-related claim has risen 60% in the first half of 2001, to \$250. And that comes after a 28% hike in 2000. In response, companies such as Allstate and Farmers Insurance Group are tightening their standards. Some are even denying new policies for homes with previous



TEXAS DELUGE Tropical Storm Allison has driven up homeowners' premiums

the \$4.6 billion losses for all of 2000. Tropical Storm Allison, which swept through Texas and Louisiana, accounted for \$2.5 billion of this year's losses. "One look at the Midwest weather map for

2001 will show that we have been repeatedly hit by severe storms and tornadoes, making it one of the two worst quarters in a decade," says Ray Hughes, vice-president of property and casualty at insurer Safeco Inc. So far this year, Safeco has increased rates by 8%, yet it warns that hikes could total 28% to 33% over the next three years.

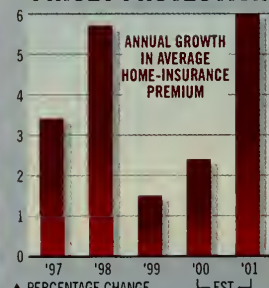
Texas has been hardest hit. Homeowners there already face premium hikes of 25%. That figure could climb as high as 50% by

claims for water damage. That has caused so much alarm that Texas Insurance Commissioner Jose Montemayor on Aug. 30 called on the state's top 20 home insurers to keep selling new policies and give him until Oct. 1 to find a solution.

Will the rate hikes be enough to improve the industry's own soggy prospects? Investors are not convinced that premiums can go high enough to offset the mounting losses. In part, that's because state regulatory bodies are likely to protect homeowners against sizable increases. "Since it's an essential product for home buyers, politicians usually take a dim view of rate increases," says Bernstein's Bault. But whether homeowners like it or not, rates have nowhere to go but up.

By Pallavi Gogoi in Chicago

PRICEY PROTECTION



▲ PERCENTAGE CHANGE
Data: Insurance Information Institute

By Michael J. Mandel

HEALTH CARE MAY BE JUST WHAT THE ECONOMY ORDERED

History teaches that the sectors that manage to grow during a downturn are often the ones that drive the next expansion. The willingness of consumers and businesses to increase spending on information technology during the recession of 1990-91, for example, foreshadowed the tech boom of the 1990s.

This time around, information technology is tanking.

But you might be surprised at what's taking its place.

Health care is driving the lion's share of what growth there is in the current economy. It may do so during the eventual upturn as well. Adjusted for inflation, the health-care sector—which includes everything from cutting-edge biotech research and drug manufacturing to hospitals and nursing homes—has accounted for 30% of gross

domestic product growth over the past year. By comparison, the housing sector—which many economists see as responsible for keeping the economy afloat—has generated only about 18% of GDP growth.

Equally significant, health care generated about 45% of all new jobs over the past year. In contrast, the entire housing sector—including construction workers, mortgage brokers, and employees at stores such as Home Depot—accounted for only about 25% to 30% of job growth. And it isn't simply a case of medical-care spending holding its own while everything else slows. Health-care

job growth over the past year has accelerated to an annual rate of 2.4%, compared with 1% a year earlier. Meanwhile, job creation elsewhere in the economy has fallen to near-zero.

What's more, the high-tech "lab coat" sector of health care has been growing faster than the "bedpan" industries. Employment at drug companies has risen 4.5% over the past

year, compared with only about 1% for lower-skilled nursing home and home health-care jobs.

It may seem odd that one sector of the economy can be so robust amid overall weakness. But it's the result of the same forces that are sending health-care insurance premiums soaring (page 46). For one, an aging U.S. population is demanding more care. At the same time, real disposable income per person is up 14% over the past five years and still rising, despite the slowdown. This

gives Americans the ability and desire to pay for more health care. And two decades of heavy investment in biotech and medical research are finally bearing fruit in the form of new drugs and treatments.

Still, many skeptics argue that growth driven by health care is as much a drain on the economy as a boost because higher health-care costs serve as a sort of tax on consumers and business. Indeed, it's quite possible that a big chunk of health-care spending is wasted.

But remember that not so long ago, the economics profession

mostly dismissed spending on computers as frivolous and not important for economic growth. It wasn't until the late 1990s that most economists conceded the positive impact of the computer revolution.

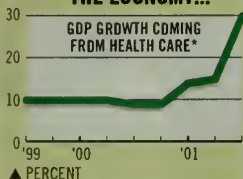
REAL IMPACT. Similarly, medical innovations may, in fact, be contributing more to economic output than the numbers show. Improvements in physical and mental capabilities—the result of, say, better asthma treatments or more effective drugs for depression—are important outputs of the economy, just like clock radios or the development of an ad campaign. Unfortunately, they are not currently directly measured as part of gross domestic product.

If health-care innovation turns out to be the leading edge of the economy during the next decade, it may be necessary to rethink what we mean by growth. It would not be the first time. Over the past 15 years, the official statistics have been systematically revamped to better capture the nature of the information economy. The statistics may need another overhaul to better track the impact of medical spending.

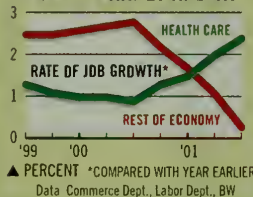
But even without such changes in the statistics, the shape of the next recovery is starting to appear. If the Information Revolution propelled the first decade of the New Economy, its second decade may be marked by the Health-Care Revolution. And there's nothing wrong with that.

Mandel covers the economy from New York.

HEALTH CARE IS BOOSTING THE ECONOMY...



...AND KEEPING THE LABOR MARKET AFLOAT



▲ PERCENT *COMPARED WITH YEAR EARLIER
Data Commerce Dept., Labor Dept., BW



EDITED BY MONICA ROMAN

THE CITI SOMETIMES SLEEPS

AUTOMATED TELLER MACHINES, online banking services, and debit-card networks crashed in the U.S. at Citigroup, the country's largest bank, on Sept. 4. The culprit? A problem with the bank's proprietary software. By midday on Sept. 5, at least one ATM at all U.S. Citibank locations was working, according to spokesman Keith Anderson. The online and debit-card functions were still down, however, and the bank could not say when they would be fixed. Citibank added 500 telephone customer-service representatives to answer questions, Anderson says. But on the evening of Sept. 5, some customers said they were unable to get through on the phone. Citigroup has more than 2 million debit-card customers and 750,000 online banking customers. The bank said it would refund any charges or fees that

Citi customers pay to use other banks' ATMs.

GETTING BIGGER IN BIG OIL

CONSOLIDATION CONTINUES IN the energy sector: Texas oil-field-services companies Global Marine and Santa Fe International agreed to a \$6 billion merger that would create the world's second-largest offshore drilling contractor. In the oil and gas production sector, Oklahoma's Devon Energy said it would buy Canada's Anderson Exploration for \$4.6 billion. Last month, Devon agreed to buy Mitchell Energy & Development for \$3.1 billion. Together, the deals will make Devon North America's largest independent production outfit for oil and natural gas.

A BREACH OF CONFIDENTIALITY

ON AUG. 23, A NEW YORK state appeals court publicly censured lawyer Steven Lyon Holley for improperly disclosing a sealed court document to a reporter from *BusinessWeek*. In 1995, Holley, a partner at Manhattan's Sullivan & Cromwell, gave reporter Linda Himelstein a copy of a motion that had been filed by Procter & Gamble as part of a fraud lawsuit against Bankers Trust. That document contained details about the bank's sales practices that eventually formed the basis for "The Bankers Trust tapes" (Cover Story, Oct. 16, 1995). In its ruling, the court said that Holley had failed to take the ordinary level of precaution mandated by state disciplinary rules and had violated Sullivan & Cromwell's own policies. It noted that the purpose of the punishment was "to put attorneys on notice" of the importance of maintaining confidentiality.

HEADLINER: RONALD SARGENT

STRAIGHTENING OUT STAPLES

AS A TEENAGER, RONALD Sargent faced a choice: Pursue a career as a jammer for a professional Roller Derby team or go to Harvard University. Sargent chose Harvard, but he'll still need sharp elbows in his new job. On Sept. 5, Sargent, 46, was named chief executive of office-supply giant Staples, effective Feb. 3, 2002. The 13-year Staples veteran and chief operating officer replaces longtime CEO and founder Thomas Stemberg, who becomes executive chairman.

After growing rapidly for most of its 16 years,

Staples has hit a rough patch, with six straight quarters of flat or declining profits. What's more, a recovery is in full swing at rival Office Depot, whose stock has nearly doubled this year vs. a 30% gain for Staples.

"We do feel like we've hit bottom," says Sargent, who expects profits to start turning up in the third quarter. But Sargent also says he doesn't expect the economy "to bail us out." His top priority is to keep customers coming in the door by improving service at the chain's 1,300 stores.

Geoffrey Smith



AN AUSSIE BANK'S PROBLEM CHILD

U.S. INTEREST RATES CONTINUE to take their toll on National Australia Bank. The country's largest financial institution said on Sept. 3 it would take a \$1.75 billion charge to reduce the value of HomeSide Lending, a U.S. mortgage lender it bought in 1998. This is the second such charge for National Australia, which said on July 5 it would take a \$450 million charge to revalue HomeSide's mortgage assets. On Sept. 4, the bank said that HomeSide CEO Hugh Harris, President Kevin Race, and CFO Blake Wilson had left the company.

devices as computers, cell phones, and fiber optics 35 times as fast as those on the market today. The discovery also makes it possible to build some chips much more cheaply. Among the applications that could result from the new chipmaking process: creating integrated circuits that would sharply cut the price of connecting high-speed Internet networks to the home—and would also hasten the arrival of radar systems to help cars avoid collisions. Motorola expects to begin selling the new chips in 2003.

ET CETERA...

- Boeing opened its new world headquarters in Chicago, relocating from Seattle.
- Exodus Communications Chairman and CEO Ellen Hancock resigned on Sept. 4.
- AIG will face competition in China from other foreign life insurers for the first time.

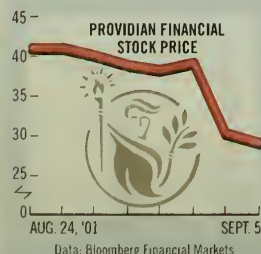
SWIFTER CHIPS AT MOTOROLA

ON SEPT. 4, MOTOROLA announced a manufacturing breakthrough that will make the silicon chips used in such

CLOSING BELL

CREDIT CRUNCH

Providian Financial is feeling pinched as consumer spending slows. The San Francisco credit-card issuer, which lends to folks with shaky credit records, said on Sept. 4 that it's cutting profit forecasts. The news sent shares sliding 22% that day, to \$30.36, and an additional 4.8% on Sept. 5, to \$28.90.



LEE WALCZAK AND RICHARD S. DUNHAM

CAPITAL-GAINS, POLITICAL LOSS: WHY BUSH WON'T BITE

If you want to peer into the past, you could dig up a time capsule buried in some building foundation. Then again, you could just visit Washington, where politicians are staging a fall spectacle in retro-politics.

Starring in this season's revival are congressional Democrats, who have reverted to their ancient tactic of accusing Republicans of pillaging Social Security. But now, they must are top billing with Senate Minority Leader Trent Lott (Miss.), whose prescription for battling the economic slump an emergency cut in capital-gains taxes. Lott wants to trim the current 20% rate to 15% for 10 years. After that? It's anyone's guess.

Since the Dems' scare-the-seniors campaign about as subtle as heaving a brick through a rising home window, let's examine the conservatives' latest supply-side foray. Although President Bush is already on the defensive over his \$1.35 trillion tax cut and a vanishing budget surplus, supply-siders and Wall Streeters insist that more cuts are needed to fast-track the economy out of an investment-led slump. Capital-gains reductions have been "a no-brainer for the market and economy in the past," notes Robert Stovall, a strategist for Prudential Securities. "It stimulates profit-taking and a reallocation of funds back into the market."

ALL-OFF? But how to pay for Lott's idea? Because a lower differential between ordinary income tax rates and capital-gains rates would spark a wave of stock sales, the Treasury would see a temporary surge in tax collections—about \$2 billion a year, Lott thinks. If the cut is put on the books, as conservatives hope, the tax tables turn, however. A similar idea passed by the House in 1999 would have lost \$51 billion over 10 years, according to the Congressional Joint Committee on Taxation.

Cost issues aside, there's the question of whether further stock sales would be good for an already shaky Dow Jones in-

dustrial average. Worries Jeff Lemieux, an economist at the Progressive Policy Institute, a centrist Democratic think tank: "As people sell stock for capital gains, it will cause stocks to fall. That could reduce confidence even more." (A more targeted approach is favored by Senators Joseph I. Lieberman (D-Conn.) and Orrin G. Hatch (R-Utah). They would eliminate capital-gains levies on just small companies and startups.)

The biggest problem with Lott's plan is political. President Bush has labored to structure his tax cut as a series of reductions for individuals. By pushing a capital-gains break now, Republicans on Capitol Hill open themselves up to another Democratic broadside that blasts the GOP for favoring the wealthy. Indeed, 69.5% of the cap-gains relief would go to the top 1% of wage earners, according to Citizens for Tax Justice, a liberal advocacy group. "The distributional problem makes it very difficult for Bush to embrace this proposal," says Marshall Wittmann of the Hudson Institute. "Plus, it would guarantee that Bush crashes into the Social Security lockbox. There's no way he can say yes."

If that's the case, what was the President up to on Sept. 4, when he said he was willing to "take a look" at Lott's proposal? Once again, the Prez is trying to tiptoe across the policy divide that separates his brand of populist conservatism from the Hill GOP's unabashedly pro-business approach. Bush doesn't want to undercut Lott and the supply-siders—or close the door to an eventual capital-gains cut as part of a new tax-reform blueprint.

But in the short term, White House officials think Lott's proposal is spectacularly mis-timed. That's why Wittmann and other Republican mainstreamers conclude that "Bush's 'look at it' translates into 'fuhgedaboutit'." There's no way Bush can go there this year.

With Rich Miller and Lorraine Woellert



LOTT: From 20% to 15%?

CAPITAL WRAPUP

GRAMM: A LATINO SUCCESSOR?

► Republican Phil Gramm's Sept. 4 retirement announcement set off a wild scramble that could result in the election of Texas' first Latino senator. Among the GOP prospects: Representative Henry Bonilla, a rising star in the House. The early Democratic front-runner is former state Attorney General Dan Morales. Also in the Dem mix: Representative Ken Bentsen, nephew of ex-Senator Lloyd Bentsen, and business-friendly Dallas Mayor Ron Kirk.

PITT'S QUIET PUSH

► When Gramm was deposed as Senate Banking Committee chairman after Democrats seized the Senate, Wall Street's hopes for streamlining Depression-era securities laws were dashed. But new Securities & Exchange Commission Chairman Harvey L. Pitt is raising financiers' spirits by promising to achieve through regulation much of what Gramm promised by law.

The first thrust: SEC staffers invited securities lawyers and brokers to suggest ways to speed up the registration

and offering of new stocks. The American Bar Assn. proposes letting companies approach investors with a wider array of sales literature, relying on antifraud protections to head off "blue-sky" promises. Another key goal: replacing paper prospectuses with Internet access to company disclosures.

So far, Pitt's quiet push hasn't caught flak from Congress. But any attempt to rewrite rules that directly affect investor protection will put the SEC on a collision course with Banking Committee Chairman Paul S. Sarbanes (D-Md.), a fierce critic of Wall Street's ways.

IMMIGRATION

HELP WANTED

Germany starts wooing skilled workers

When the German government celebrated completion of the new Chancellor's Office in Berlin on Sept. 1, musical entertainment came from five dancing and singing women, average age 22, known as No Angels. The group, currently the nation's most popular pop act, might as well be called No Germans. Although most were born in Germany, ethnically their roots lie in places like Peru, Morocco, and Bulgaria, with just one blue-eyed Nordic blonde among them.

A policy statement? It could have been. Germany looks on the verge of passing a law that will for the first time allow selective immigration, especially for those with sought-after skills in areas like math and science. The proposal by Interior Minister Otto Schily faces criticism from both left and right, but all the major parties agree on the need to encourage orderly immigration. Putting out the welcome mat represents a 180-degree policy turn for Germany, which has long denied being an immigrant nation, even though loopholes have let in

"guest workers" and political refugees. Those waves of *Ausländer* have pushed the foreign-born population to 9%. In cities like Frankfurt, 28% of residents are foreign born.

Now, Germany seems ready to institutionalize what has long been fact. Schily's proposal would create an orderly system for accepting foreigners and integrating them into society. Foreigners with the most education and skills would be welcomed, offered instruction in the German language and local customs, and given expedited treatment from the bureaucracy. Most important, mathematicians and other highly qualified foreigners would be eligible for permanent residency immediately. "The country needs to offer scientists a secure future," says Manh Ha Duong, a 28-year-old Vietnam native who came to Germany as a student and now helps prepare forecasts for the German Institute for Economic Research in Berlin.

Anti-foreigner sentiment has long been a favorite campaign theme of Germany's center-right Christian Democratic

Union.

The party used it to win control of Parliament in the state of Hesse in 1992. Yet now, economic pragmatism seems to be gaining the upper hand. While the CDU objects to some provisions of the proposed immigration law, a compromise is likely. "I'm surprised," says Hans-Otto Henkel, former CEO of IBM Europe, the Middle East, and Africa, and a member of the government's Immigration Commission. That "was unthinkable two years ago."

The shift in attitude is part of a continental trend. Even as European countries



CAPTURED: Illegal African immigrants in Spain

EASING UP—BUT ONLY A LITTLE

Britain Stepping up efforts to block illegal immigrants arriving via the Channel Tunnel and other routes. But accepted 125,000 legal immigrants last year, an increase of 80% since 1998.

France Liberalized immigration law in 1997, boosting number of immigrants 40% last year, to 120,000.

Italy Raised quota of non-EU nationals this year by 15%, to 83,000 slots. Business wants more, though anti-foreigner National League could block reform.

Germany Likely to create its first system to encourage orderly immigration, with preference given to people with education and skills. Passage expected by early 2002.

Spain Battling to stem flood of North Africans crossing Straits of Gibraltar in rickety boats. Yet illegal immigrants have helped fill low-wage jobs and fuel an economic boom.

Data: BusinessWeek



zone is 8.3%. Yet in Germany and other EU countries many people are profoundly reluctant to relocate. Generous jobless benefits, which in the first year pay people two-thirds of their previous salary, reduce the pressure. Andy Zynga, Frankfurt-based group director for Vanco, a British provider of telecom network services, remembers trying to recruit a salesperson in Hamburg who was about to lose his current job. "He canceled the interview because he wasn't willing to move from Hamburg," recalls Zynga.

LOCAL FRICTION. Italy has a similar problem. Unemployment in the south reaches as high as 20%, but it dips as low as 5% in parts of industrial northern Italy, creating a shortage of skilled workers. Marco Trapani, 37, a Sicilian-born truck driver, has been unemployed for six years. He was the only applicant to respond to a shipping company's want ad, offering \$2,000 per month, free housing, and relocation assistance to Brescia, which lies between Milan and Verona. "I went up to Brescia to check it out, and I felt more out of place than the African immigrant next to me on the train," says Trapani.

If Germany does pass its new law, the pressure to open the doors even further will increase. But the Christian Democrats want tougher measures to prevent people from using political asylum to gain entry. And they want assurances that Germany isn't opening the floodgates. Meanwhile, the Greens, coalition partners with Chancellor Gerhard Schröder's Social Democrats, consider the proposed law inhumane because it bars immigrants from bringing

in children over 12.

Despite the bickering, reform is likely sooner rather than later. Interior Minister Schily vows to pass a law before the end of the year. All major parties agree that the country needs foreigners. "I'm all for it. It's more necessary than it has ever been," says Herbert Mai, director of personnel at the Frankfurt Airport and former head of the union that represents Germany's public service workers. An increasing

will shrink
to 26 million from

41 million. Without enough young working people, the pension system will collapse. Moreover, the war for talent is now global. Germany's current policy, which officially welcomes only those of German ancestry, has already put the country behind the U.S. and Canada in attracting the world's best minds.

Not that Germany lacks foreigners. During the "Economic Wonder" years of the 1950s and 1960s, the government allowed immigrants to man the assembly lines of companies like Volkswagen.

The largest group were Turks, who started arriving in the 1960s. These guest workers were supposed to return home, but Germany never seriously pressured them. Many stayed and raised families, and now Germany's 2 million-plus Turks are the largest foreign ethnic group. Germany also accepted some 345,000 Bosnian refugees during the height of the ethnic conflict in the former Yugoslavia.

But now Germany wants skilled workers for good-paying jobs. That seems illogical when Germany has 3.8 million unemployed people, and the unemployment rate in the euro

Foreigners In Germany

Where they come from:

TURKEY	2,054,000
YUGOSLAVIA	737,200
ITALY	615,900
POLAND	291,700
CROATIA	214,000
BOSNIA	167,700
U.S.	112,000

Total population: 82.164 million*

*End 1999 Data: Federal Statistics Office

number of Germans agree.

By Jack Ewing in Frankfurt, with Kate Carlisle in Rome, Kerry Capell in London, and bureau reports

ies like Britain and Spain step up attempts to shut out illegal immigrants from poor lands, they are welcoming foreigners with desirable skills. No huddled masses, please. But give us your scientists, your engineers, your computer programmers yearning to write code. It's clear that we don't have enough chemistry or machinery graduates," says Thomas Schoeneberg, chief of personnel at Frankfurt-based chemical company Degussa.

While Germany debates its proposed immigration law, Britain and France are already issuing more residency permits to skilled foreigners. Ireland, with unemployment below 4%, plans to import 100,000 workers over the next five years. Government recruiters have held job fairs in New Zealand and India. Until recently immigration just wasn't a feature in Ireland, but with the huge growth in the economy and subsequent skills shortage it became a more pressing issue," says Jackie Harrison, director of social policy for the Irish Business and Employers Confederation.

The economic argument is compelling. European population growth is slowing, and the average age is rising. The demographics are most ominous in Germany. At current birth rates, Germany's population will fall to 60 million by 2050 from 82 million today. The workforce



JAPAN

ALL EYES ON A TEETERING ECONOMY

A diving Nikkei, shrinking GDP—how bad can things get?

It seems as if the financial meltdown that has afflicted Japan for a decade will never end. The newest signs of crisis include a free-falling Nikkei stock index, a rash of losses in the country's vital electronics sector, and fresh worries about Japan's debt-drunk banking system. Most embarrassingly, the International Monetary Fund has shifted

its focus off the developing world and cast a gimlet eye on Japan: The fund is pushing to send in a SWAT team of examiners to pore over the books of Japan's banks. Meanwhile, Hakuo Yanagisawa, Japan's Minister for Financial Services and the point man in the bank workout, has been offering a more optimistic view of Japan's crisis.

How bad could things get? Here's a primer:

Is the situation so dire that Japan needs an IMF inspection?

The Washington-based fund recently issued a critical report on Japan's banking system that cast doubt on official bad-debt figures. Financial Services Minister Yanagisawa insists that 11 major banks can afford to write off \$145 billion in nonperforming loans in three years without an injection of public funds. The IMF is worried that Tokyo is downplaying a potential crisis involving not only acknowledged bad loans but also an additional \$70 billion in debt whose repayment is in question. Meanwhile, private firms, including Goldman, Sachs & Co., have estimated that Japan's level of nonperforming loans is four or five times higher than Tokyo is admitting.

Will there be big bank collapses?

That's unlikely in the near term. A \$50 billion capital injection in 1999 shored up the capital-adequacy ratios of the biggest banks. Smaller lenders and regional banks could go down, but the government is offering 100% blanket protection of bank deposits. An added issue is the practice Japanese banks have of including their stock portfolio in their capital base. Even though the collapsing Nikkei is hitting these portfolios, stock market declines probably won't sink the banking sector. Major banks have capital-adequacy ratios of around 10%—above the

8% they need.

So why is the IMF so concerned?

If Japan's banks don't clean up the loan books once and for all, they won't be doing much lending, and Japan won't have growth for years to come. That hurts Asian trading partners such as South Korea, Singapore, and others that trade heavily with Japan. Japan's \$4.4 trillion economy is burdened with huge excess capacity and debt. Only a cathartic and painful shakeout will fix it.

How many jobs are at risk?

Plenty. Japan's jobless rate is already at a postwar high of 5%. Goldman Sachs analyst David M. Atkinson thinks new unemployment will eventually hit 20 million. Atkinson's numbers mean a job

ss rate of about 8.5%—horrendous by historical standards.

What's behind the collapse of the Nikkei index to a 17-year low?

Foreign investors are heading for the exits as the Japanese economy decelerates. Just about every major indicator, from industrial production to consumer spending, is flat or heading south. Figures scheduled to be released on Sept. 7 for the April-to-June quarter are likely to show that the economy contracted at an annualized rate of 4% or more. The U.S. tech bust and soft global demand for chips and all manner of info-tech gear is creating huge losses for blue-chip companies such as Hitachi, Toshiba, and Fujitsu. Japanese bank and tech stocks account for about 35% of the market capitalization on the Tokyo stock Exchange.

Who is Prime Minister Junichiro Koizumi likely to back off from his plan for tough reforms?

Well, he is certainly in a jam. The economy has nosedived since he took over in April, though he has hardly begun the dolorous restructuring he promised. If Koizumi does a U-turn, abandons fiscal austerity, and resorts, like his predecessors, to big spending packages and new borrowing, investors could exit Japanese bonds en masse, which could send prices plunging and further aggravate the economic downturn. Koizumi is scheduled to release a detailed blueprint of his plans by mid-September.

Things sound grim. Can we expect a sustained recovery in Japan anytime soon?

Koizumi has argued that it will take three years of tough economic times to shake the banks, put deadbeat corporate borrowers out of business, and set the stage for a new period of growth. To get there, he'll need help. Japan's chief export market, the U.S., will have to begin to recover by 2002. And to further boost export growth, the yen will need to weaken dramatically, from 118 to the dollar to maybe 130—a level Japanese officials suggest they'd be comfortable with. Banks, meanwhile, must get ruthless with troubled borrowers. All of this is extremely tough to do politically. And remember, this is Japan, where things move slowly. So the rest of the world is going to have to cope with a very weak Japanese economy for years to come.

By Brian Bremner in Tokyo

JAPAN

NINTENDO'S GAME ISN'T OVER YET

GameCube may be hot enough to challenge Sony

It has been years since Nintendo could claim the top spot in the \$20 billion video-game universe. Over the past six years, Sony Corp.'s popular PlayStation has grabbed share from Nintendo 64. With the imminent arrival of Microsoft Corp.'s Xbox, everyone figured that Nintendo would fall from second place to a distant third.

Nintendo, however, is determined to duke it out. Its weapon of choice: GameCube, a new console that hits the Japanese market on Sept. 14. Industry execs and analysts are enthused. "Nintendo's games are dazzling, and its new [\$199] machine is priced to sell," says Romain Poirot-Lellig, managing partner of Paris-based Interactive Finance, which invests in game stocks. "I think [Nintendo] can make a comeback."

Nintendo is betting everything on a contrarian, back-to-basics strategy. Sony and Microsoft are pushing black boxes designed as home entertainment centers that play DVD movies and music CDs as well as games. Nintendo's colorful, compact machine plays just one thing: games.

Nintendo also believes that customers are ready for easy-to-play yet entertaining games. It's offering a tempting array, ranging from new versions of classics based on Mario the plumber, Zelda, and Donkey Kong to new additions like Pikmin, in which an ant-like creature helps you, a stranded astronaut, survive on an alien planet. "We believe the \$20 billion video-game industry is still rooted in basic game play," says Peter Main, executive vice-president of Nintendo of America.

The 128-bit GameCube is expected to lure core fans, namely North American and European families. The question is whether it can sell in Japan. "You

need the Japanese market to get the game developers on board," explains Microsoft managing director Hirohisa Ohura, who is overseeing the Japan launch of Xbox. He has lined up 70 Japanese developers who are working on 130 titles.

Nintendo has learned from its mistakes and is wooing developers, too. For years, it stuck with silicon cartridges that were difficult to design for and alienated game developers. For GameCube, Nintendo chose an optical disc as storage medium; it offers game designers an easy platform to work on. As a result, Nintendo hopes to release a dozen game titles before yearend—a company record.

Nintendo needs a winner. Declining sales of N64 and Game Boy, combined



PLAYING IT COOL

Will the new GameCube restore Nintendo's earnings?



TRYING IT OUT

Nintendo thinks gamers will go for the no-frills unit

with the cost of shifting over to GameCube and Game Boy Advance, have hit earnings hard. In fiscal 2000, operating profit fell 42% over the previous year, from \$1.2 billion to \$700 million. For GameCube to provide a boost, Nintendo needs to zap its rivals. Sony will still be troublesome, but Microsoft may be less of a threat than anticipated. Technical glitches have forced a delay in the Japan debut of Xbox from this year to next, and Microsoft's games failed to inspire at a recent trade show, while Nintendo's were a big hit. Mario the plumber takes on the Beast of Redmond? That's a game worth watching.

By Irene M. Kunii in Tokyo

BusinessWeek online

For an interview with Financial Services Minister Yanagisawa go to the Sept. 17 issue online at www.businessweek.com.

INDIA

CAN MURDOCH'S STAR KEEP RISING IN INDIA?

A laggard for years, Star Plus has 36 of the top 50 TV shows

The Virani family is all aflutter. Son Mihir has reappeared after an absence during which he nearly died. Suffering from amnesia, he has no recollection of his family. Nor can he recall falling in love with the beautiful doctor who nursed him back to health and recently announced she is having his child. Meanwhile, Mihir's wife, Tushi—the ideal Indian daughter-in-law—is also pregnant by her resurrected husband.

An improbable plot. A bout of amnesia. A love triangle. It's classic soap opera. *Kyunki Saas Bhi Kabhi Bahu Thi* ("Every Mother-in-law Was Once a Daughter-in-law") is currently the most popular TV show in India, seen by an estimated 20 million viewers every week. The surprise is not that *Kyunki* is a hit—after all, it deftly mines the disquiet Indian families feel as they con-

front the globalization of their culture. The real shock is that the show appears not on Zee TV or Sony TV but on Star Plus, the once ailing channel owned by Rupert Murdoch's News Corp. Star Plus, the flagship Indian channel of Murdoch's Star TV network in Asia, has lagged for years. Now, it boasts 36 of the top 50 shows in the country. "India is going through a sea change, part old world, part new world," says Anil Wanvari, founder of Bombay-based industry tracker Indiantelevision.com. "Star's programs have hit a chord."

HINDI REVERSAL. It's a remarkable reversal of misfortune. Just 14 months ago, almost nobody watched Star. The problem: not enough Hindi programming. Under a partnership pact set up in the 1990s with Zee, Star had agreed not to broadcast more than half of its



THE ANSWER: Star's Hindi version

shows in Hindi. As a result, its ratings stayed low while Zee's soared. So last year, Murdoch sold the 50% stake in Zee back to its founder, Subhash Chandra, for \$300 million. That opened the way for Star's first hit, a Hindi version of the game show that swept America: *Who Wants to Be a Millionaire?*

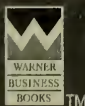
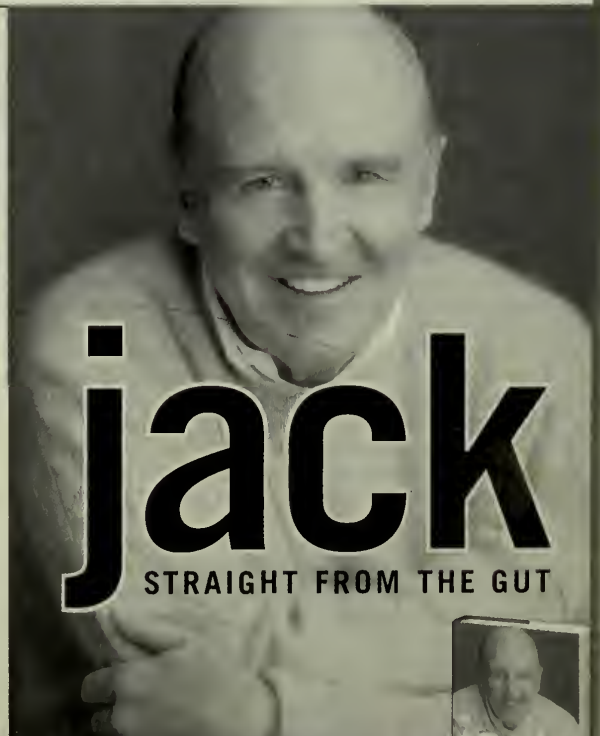
Ratings soared, and advertisers bought air time at four times the going

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executive. "It has gloss, glam, and razzmatazz."

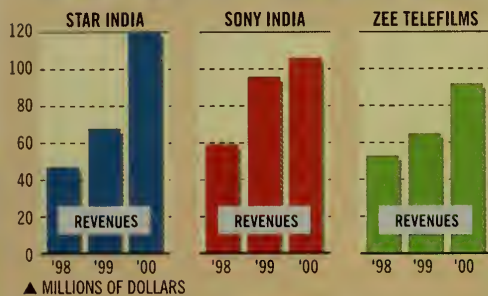
All that glam has the competition on the offensive. Archrival Zee is launching 24 new programs, including game shows and soaps shot in the exotic locales Indians love. Viewer response has yet to be assessed, and top advertisers, such as confectioner Britannia, haven't deserted Star. Still, Sandeep Goyal, Zee's CEO, confidently claims: "We'll have Star on the run. In six months, we'll top them." For its part, Sony has four new offerings in the pipeline, including India's first reality show and talent contests. Even state-owned Doordarshan is planning a matchmaking show anchored by a megastar.

Star is working hard to hold on to its lead. It has a dozen new shows in the works and is lobbying for legislation that will allow direct-to-home TV in India, giving Star the chance to boost its profits. In August, it bought 50% of Madras-based Vijay TV, which could give Star a hold in the lucrative south.

Star hasn't won the war, however. Critics say its high advertising rates will be hard to sustain, now that the novelty of *Millionaire* and the daily soaps is wearing off. Apart from its Hindi movie and two sports channels, Star's other five channels carry mostly recycled Western fare. Besides, Zee's Chandra is looking to sell 50% of his company, and Bombay bankers say AOL Time Warner, Viacom, and Vivendi Universal have all expressed interest. Murdoch & Co. will need to keep Indian viewers glued to their screens.

By Manjeet Kripalani in Bombay

PRIME TIME: STAR TWINKLES ANEW



Data: Indiantelevison.com

You have a family and a job. Do you have a life?

TIME — that's the problem. So many hours at work taking precious time away from your family. Making a living has gotten out of sync with making a family and having a life. "Juggling Work and Family" is a bold and sometimes chilling documentary that examines this national epidemic. Join veteran broadcast journalist Hedrick Smith as he probes new and resourceful solutions to what you might have thought was a no-win dilemma. You might even see yourself.



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EDITED BY ROSE BRADY

WILL IRAN'S MULLAHS OVERPLAY THEIR HAND?

There is an old saying in Iran that once you let a mullah ride your donkey, it is very hard to get him off. In the same vein, Iranians, who voted overwhelmingly for reform President Mohammad Khatami in last June's elections, are having a terrible time shaking off the influence of hard-line religious conservatives.

While Khatami won about 70% of the vote, hard-line clerics, who didn't even put up a candidate, have been acting as if they were the winners. In August, they managed temporarily to hold up Khatami's inauguration. They have also taken to tagging public floggings in parks and on traffic islands in Teheran to punish drunkenness and fraternization between unmarried men and women. Their aim is to remind Khatami, as he forms his new government, that the conservatives still have clout.

Although they have lost control of the executive branch and the Parliament, this group of clerics, led by judiciary chief Mohammad Hashemi Shahroudi and Ayatollah Ahmad Jannati, retains control over law enforcement. It dominates the Council of Guardians, a body that has sweeping powers of review. In the past, conservatives have also enjoyed a great deal of success in convincing Supreme Leader Ali Khamenei that Khatami's program is largely about "sex, drugs, and rock 'n' roll," as one Iranian political scientist puts it. In his first term, which began in 1997, Khatami did a poor job of convincing Khamenei, who is potentially the most powerful figure in Iran's hydra-headed political system.

SUBTLE GAME. Along with disappointing many Iranians, the recent backlash could damage hopes for improving the country's struggling economy, which badly needs outside capital and knowhow. The infighting can't help but sow doubt in the minds of both Iranian and foreign investors, who had hoped that the political jousting would lessen after the June

vote. "I am sure that a lot of foreign companies are reassessing political risk in Iran," says Bijan Khajepour, managing director of Atieh Bahar Consulting in Tehran.

In response, Khatami and the reformers have to play a subtle game. They are rolling with the punches, hoping that the hard-liners will overplay their hand. The more the mullahs use their control of the judiciary to enforce their positions on social issues, the more unpopular they become with the public. Hard-liners "are making a clear stand now—and this has costs," says Abbas Abdi, a left-wing journalist.



STRAINS: Khamenei, Khatami

Meanwhile, Khatami is working out a modus vivendi with the Supreme Leader, who, despite his conservative instincts, realizes that the clerics' obstructionism could eventually backfire. Khatami has learned to proceed cautiously. He hasn't put any controversial reformers in his new Cabinet, for example. That's in contrast to his first term, when outspoken Interior Minister Abdullah Nouri landed in jail and other key aides were forced out.

"MORE PROFESSIONAL." Even so, Khatami may now have the personnel he needs to push through reforms such as privatization and devolving more power to local governments. His new Finance Minister, Tahmasab Mazaheri, an ex-presidential adviser, can only be an improvement on his predecessor, Hosein Namazi, a 1960s-style Third World socialist. "This is a more professional Cabinet," says Saïd Laylaz, a prominent Teheran economist. Khatami has cut a deal with conservatives to open the country more to investment.

Still, hard-liners will not yield their power easily, even though their rule has left Iran impoverished and lagging behind much of the world in many fields. Khatami holds out hope of beneficial change, but it's going to be tough for him to deliver.

By Stanley Reed in London and Haleh Anvari in Teheran

GLOBAL WRAPUP

RUSSIA SEEKS SPACE TOURISTS

► Dutch-based MirCorp is planning to build and launch the world's first commercial space station by 2004. The company, 60% owned by Russian aerospace giant Energiya, ran out of time in its attempt to turn Russia's creaking Mir space station into a hotel before it crashed to earth last March. Now, MirCorp aims to modify existing Russian-made Soyuz modules to hold up to three cosmonauts, including space tourists, for 20 days. Russia's space agency, Rosaviakosmos, must ap-

prove plans for the space station, which could cost \$100 million. Indeed, the cash-strapped agency is hoping to get a 20% cut of profits from charges of \$20 million per person per trip. MirCorp executives say 15 potential space tourists have voiced interest.

COURT RULES FOR CHIRAC

► French President Jacques Chirac's reelection prospects are looking brighter. On Sept. 4, an appeals court removed a magistrate who spearheaded an investigation of alleged corruption during Chirac's 1977-95 tenure as Paris

mayor. The court accused magistrate Eric Halphen of procedural errors and threw out key evidence he had collected, including a taped confession by a former political operative who linked Chirac to payoffs. Even before the ruling, polls showed Chirac running ahead of Socialist Prime Minister Lionel Jospin, who plans to challenge Chirac next May but is taking the heat for rising unemployment. Also on Sept. 4, Jean-Pierre Chevènement, a former member of Jospin's cabinet, announced he would run for President—a move that could splinter the leftist vote.

BUSH'S 50.1% SOLUTION

He needs to change just a few minds in key states by 2004

At first blush, you might think President Bush would have better things to do than spend Labor Day with union members who voted overwhelmingly for Al Gore. But there he was at a carpenters' training hall in Kaukauna, Wis., donning yellow work gloves and hard hat, his gray button-down shirt soaked with sweat as he practiced the training regimen for millwright apprentices. Later, it was on to Michigan for a Teamsters barbecue. "We don't necessarily agree on every single issue," Bush told the union members in Detroit, "but we agree to listen."

The Sept. 3 events aren't the first time Bush has tried to woo former foes. From Latinos to African American men, from Arab Americans to Eastern and Southern European Catholics, the White House has embarked on an inch-by-inch effort to increase the President's support among key constituencies that resisted his candidacy in 2000.

"INCREMENTALISM." What's unusual is that GOP strategists aren't expecting the President to win a majority of these votes in 2004. After all, just 1 in 10 African Americans and 1 in 3 union members voted for Bush. But by simply improving his performance by a few percentage points among key groups, Bush could go from narrow loser in the popular vote to majority winner. Call it the 50.1% solution. "This is the politics of incrementalism," says John J. Pitney Jr., a government professor at California's Claremont McKenna College. "When you start at 48%, gaining 3% is a tremendous advantage."

To Republican operatives, it's simple math. GOP strategists know that slight gains in the popular vote can translate into a huge difference in the only ballots that count—those of the Electoral College. The voting groups in question are



concentrated in a small swath of swing states in the Mid-Atlantic and Midwest narrowly carried by Gore, including Illinois, Iowa, Michigan, Minnesota, Pennsylvania, and Wisconsin. If Bush manages to win those states, he goes from a 271-267 squeaker in the Electoral College to a 362-176 reelection landslide.

This strategy of incrementalism—the brainchild of Bush political guru Karl Rove—is driven by the fact that Bush's brand of conservatism has failed to win

many converts among moderate and independent swing voters. While top Democrats think the GOP is wasting its time, Bush's aides think that history is with them. When Bush ran for reelection as Texas governor in 1998, he broke records for support among Hispanics and blacks (49% and 27%, respectively), after faring poorly among those groups four years earlier. As governor, Bush "was able to show he was different than their negative preconception," says Bush pollster Matthew Dowd.

White House strategists are convinced that Latinos, the fastest-growing minority group in the country, offer Bush the best opportunity to replicate that formula at the national level. If he succeeds, Hispanic voters could make the difference in competitive states such

as Florida, Illinois, New Mexico, Colorado, Arizona, and even Pennsylvania.

THE POPE AND THE PREZ: Wooing East European Catholics

To woo Latinos, Bush is backing immigration liberalization, defending some affirmative action programs, and opposing the efforts of GOP lawmakers to restrict Mexican trucks on U.S. highways. At his first state dinner, on Sept. 5, he will host Mexican President Vicente Fox. And

COBBLING TOGETHER AN ELECTORAL MAJORITY?

Having lost the popular vote in 2000, Bush strategists are trying to top 50%

TARGET: MARRIED WOMEN WITH CHILDREN

Some 3 million Republican women voted for Al Gore last year.

STRATEGY: Cut that number in half by appealing to mothers with school-age kids.

TARGET: LATINOS

Hispanics are America's fastest-growing minority group.

STRATEGY: Ease immigration laws, back some affirmative action, allow Mexican trucks on U.S. roads.

TARGET: LABOR

Unions helped tip Iowa, Pennsylvania, Michigan, and Wisconsin to Gore.

STRATEGY: Strive to boost Bush's share of the union vote in those states by about 10%.

TARGET: AFRICAN AMERICAN MEN

Fewer than 1 in 10 blacks voted for Bush.

STRATEGY: Work with black ministers on faith-based initiative, cultivate Dems such as Philly Mayor John Street.

atinos are not the only Democratic-izing ethnic group targeted by the hite House. Bush is ingratiating himself with Arab Americans, a pivotal vote oc in Michigan, by condemning racial ofiling of Middle Easterners.

Another unlikely target: African merican men, who seem more willing an black women to give Bush good arks as a person, according to poll-ers Celinda Lake and Ed Goetas. ish has consulted regularly with black inisters on his faith-based initiative, d he has sought out influential De-ocrats such as Philadelphia Mayor hn F. Street and former Queens (Y.) congressman Floyd H. Flake. If ish can double the paltry 9% he re-ived from blacks, it could alter the litical equation in Michigan, Pennsylv-ania, and Wisconsin.

ORE MOMS? While Bush's outreach to acks and Hispanics mirrors his Texas perience, his aggressive pursuit of ion votes began after the 2000 elec-on. Ignoring the Democratic loyalists AFL-CIO headquarters, Bush is try-g to cultivate industrial unions with emberships in key states such as ennsylvania, Michigan, West Virginia, entucky, Missouri, and Wisconsin. His ch: Bush energy and environmental policies will mean jobs for union families. t the same time, the White House has orked to satisfy the special pleadings particular unions. One example: The ministration is hinting that it may e ready to lift federal oversight of the eamsters.

The White House also sees an open-g among moms, another group where ash met significant resistance in 2000. rticularly painful were the 3 million OP women who crossed party lines to te for Gore. "We lost 3 million Re-blican girls," laments GOP demogra-er John Morgan. "If we get 1.5 mil-on back, it puts us over the top."

But how? Many suburban moms are rned off by Bush's social conservatism d the GOP's hard-edged partisanship i Capitol Hill. Bush's goal is reaching ut to mothers of school-age children by oting education reform and civility public discourse, and launching a fall itiative focusing on morality and values. Thus far, Bush's strategy has met ith mixed results. A recent Gallup Poll ows him locked in a dead heat with ore in a hypothetical 2004 rematch. ill, Republicans remain convinced that l the Teamster BBQs and inner-city sits will, in time, make a small but nificant difference. After all, if just 1 ut of every 50 Gore voters switches Bush, the 2004 contest won't come own to hanging chads in Palm Beach.

By Richard S. Dunham
in Washington

Management

B-SCHOOLS

TED SNYDER: CHICAGO'S HOPE

The B-school is counting on its new dean to reverse a slide



ON THE DEAN'S LIST

✓ CHICAGO'S STRENGTHS...

- High-powered faculty and strong academic reputation
- Recruiters rave about graduates' skills
- Vast but untapped alumni network

✗ ...AND WEAKNESSES

- Strained relations with the greater university
- Little sense of community among students
- Less than stellar finances and endowment

There's something wrong with Ed-ward A. Snyder's new office. "These," he says, gesturing to floor-to-ceiling bookcases lining the walls, "have got to go." Turns out they concealed exquisite neo-gothic pillars at the corners. More than that, says the new dean of the Uni-versity of Chicago Graduate School of Business, the dark wood made the room feel, well, dreary and closed off.

The same ambience could describe the B-school itself. Although Chicago's graduate business school is a formidable competitor and turns out brainy execu-tives now heading companies across the globe, it has also be-come known as an em-battled campus, mired in conflicts with univer-sity administrators and

SNYDER:

Beefing up school identity is a priority

lacking esprit de corps among its students. Fund-raising trails that of other top-tier schools, and a rigid focus on research comes at the expense of teaching, say alums. In *BusinessWeek's* 2000 ranking of MBA programs, Chicago slipped to No. 10 from No. 3, despite high marks from recruiters.

Snyder, 48, is the man who is supposed to change all that. As dean of Dar-

versity. It's partly a matter of style: Chicago doesn't send its MBAs through a core of classes together—rather, students pick and choose. “There is no focus on fostering a sense of community within the school,” noted one 2000 grad in the *BusinessWeek* survey. “The administration is ridiculously out of touch with students’ concerns.” With his frequent Sunday dinners and morning coffees with students, Snyder could

But Snyder needs to finish the building capital campaign and then wrangle fun and a site for B-school housing. On the other divisive issues, his well-known disdain for political maneuvering could trip him up, but Snyder vows “I’ll tough when I have to.”

At the same time, the pro-student dean will have to be careful not to alienate faculty, say insiders. “The best defense for me is someone who’ll leave me alone to do my research,” says Rachel Hay, assistant professor of accounting who spends 75% of her week on research. Snyder will have to combat that deep-seated attitude without jeopardizing the school’s hallmark commitment to academic research.

Snyder’s gentle suasion will also have to carry over to corporate partners at the 34,000 B-school alums, whose numbers are among the largest but are relatively untapped when it comes to writing checks. The B-school’s endowment, at about \$197 million lags behind schools like Northwestern University’s Kellogg Graduate School of Management, with \$380 million. Snyder will go after your influential alums like Julie Roehm, 31, marketing whiz who helped launch the Ford Focus. As for big gifts, Snyder secured for Darden a \$60 million gift from retired chief executive of Landmark Communications, Frank Batten Sr., whom Snyder carefully courted. The result: The Batten Institute for entrepreneurial leadership opened in early 2000.

HARBINGER. To make it come together, the dean will have to use all his talent to unite his constituents: faculty, students, corporate partners, alumni, and the university administration. It certainly helps that he already has an ally: new university president Donald Radel. A former Cornell University provost and musicologist who took over in June 2000, Radel admits that past tensions and underhanded political plays had tainted the relationship between the university and the B-school. “I want us to work on professional terms that don’t cause everything to descend to hardball negotiations,” says Radel. Many see the Radel-Snyder team as a harbinger of a new attitude at Chicago.

Snyder can ride that wave of enthusiasm until he gets his bearings and plays a strategy, something he says he’ll do the next year after extensive input from all sides. He has e-mailed each faculty member, promising to meet with all 15 in the coming months. And the first Sunday dinner with students was scheduled for September 8. At the staid campus, the charm offensive is on.

By Jennifer Merritt in Chicago



1982: School days

EDWARD A. SNYDER

BORN July 3, 1953

CHILDHOOD Born in Pennsylvania to a former World War II bomber pilot and businessman and 9th-grade teacher. Grew up in Massachusetts and Maine.

EDUCATION BA in economics and government from Colby College, 1975; MA in public policy, 1978, and PhD in economics from University of Chicago, 1984.

OUTSIDE THE B-SCHOOL BOX Set a triple-jump record at Colby College in his freshman year; Economist, Antitrust

Div., Justice Dept., 1978-82; consultant, Federal Home Loan Board/Senate Committee on Banking, examining the savings and loan crisis, 1989.

B-SCHOOL CAREER Spent nearly 16 years at University of Michigan Business School; started as an associate professor, then director of the Davidson Institute, an international business think tank, and finally, professor and senior associate dean; Darden Graduate School of Business, dean, 1998-2001; University of Chicago Graduate School of Business, dean, July, 2001.

HOBBIES Took up golf three years ago and now has a handicap of 12; plays even in the dead of winter.

FAMILY Married to Kimberly; three school-aged children.

den Graduate School of Business at the University of Virginia for three years, he was so well-loved that fellow administrators cried when he announced he was leaving. Now, the Chicago PhD in economics has returned. And if anyone can give the stodgy school the shove it needs, say many B-school educators, it's Ted Snyder. “These are fairly new challenges for him, but I think he’s a good bet to accomplish them,” says B. Joseph White, former dean at the University of Michigan Business School and Snyder’s former boss.

Bookish and academic, Snyder is at the same time a friendly sort whose soft-spoken demeanor draws people in. “He’s not someone who comes off as a big shot,” says college buddy Peter Kraft. So the toughest challenges—soothing the sorely overlooked student body and improving strained faculty-student relations—could play well to his strengths. Snyder has tapped marketing professor Ann L. McGill as deputy dean to tackle big issues, such as attracting more minorities and women to Chicago.

Indeed, graduates have complained bitterly about a lack of school identity and di-

turn the tide. “These students aren’t used to the dean stopping to talk to them,” says Snyder. “They will know that I will fight for them.”

University officials are counting on that, says trustee Dennis Keller. They’re also keen on Snyder’s financial acumen. In his three years at Darden, Snyder put the once-sluggish B-school on secure financial footing by strengthening corporate partnerships and expanding its lucrative executive education department.

What’s more, the son of a World War II bomber pilot and a high-school teacher has spent most of his adult life in the business school world, including almost 16 years at Michigan. So the political terrain—not to mention the cold climate—is plenty familiar. One mess he’ll be trying to clean up is the bitter aftermath of a protracted battle between the previous dean and the administration over the location of the B-school’s new building. The university wanted to put the \$125 million, 330,000-square-foot building at the edge of campus, where it would help move the college southward and further gentrify the area. The B-school wanted a spot close to the main quad—and won.

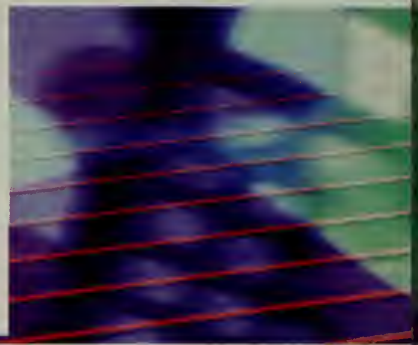
Business Process
Improvement Through

Wireless Technology

A HOW-TO GUIDE

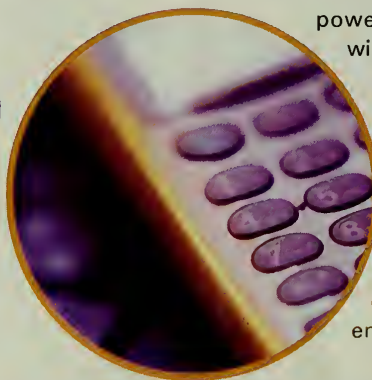


Business Process Improvement Through Wireless Technology



The Wireless Opportunity

Companies have long sought ways to restructure their business processes to achieve greater efficiency. Now taking centerstage, and promising returns to rival earlier gains, are wireless technologies.



By shattering conventional wisdom about how and where work should be performed, wireless technologies are able to:

- Free desk bound workers by letting them receive and retrieve information while on the go.
- Permit functions to be performed out of the office by shifting tasks to mobile workers equipped with powerful devices and wireless applications.
- Boost productivity by streamlining workflows and alleviating data entry burdens.
- Improve revenue-generation capabilities by shortening sales cycles,

adding new sales channels and creating new categories of product and service offerings.

- Protect investments in costly assets and equipment, and monitor remote goods or personnel.

With so many possibilities, where do you start? Start with the business process. High-value processes with the right characteristics will generate the greatest ROI and likelihood of success. The choice of process simplifies solution design, and the selection of technology.

This special section will explore how to identify the "best candidate" business processes for wireless solutions; how to select the right type of wireless solution; how to overcome wireless constraints and where to find assistance.

How to identify the "best candidate" business processes for wireless solutions

The ability to send, receive and collect data from almost anywhere creates many opportunities for business process improvement. Exchanges of even small quantities of data can provide major financial, performance and competitive benefits. With endless possibilities before us, the following questions will help identify processes that could benefit most from current wireless technologies.

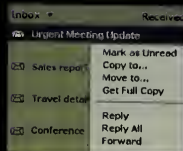
Can immediate access to information hasten decision-making or responsiveness?

Wireless solutions are ideally suited for facilitating immediate action on high-value information. For example, wireless e-mail access enables traveling executives and sales people to respond quickly to issues and customer needs. Stock and auction alerts allow quick response to market

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Wireless Technology

fluctuations. Instant access to laboratory test results can help emergency room physicians save lives.

Does knowing the location of an asset or individual have value?

Wireless location and tracking capabilities enable companies to monitor the whereabouts of shipments, equipment and employees. Potential applications include loss prevention, more efficient routing of deliveries, accu-

accuracy of data collection while eliminating the effort and expense of re-entering written notes, forms and reports. Automation possibilities include: laboratory notebooks, prescription writing, inspectors' reports and trip logs.

Would greater mobility enhance work performance?

A wireless device frees professionals to spend more time on mobile tasks

such as negotiating contracts, meeting customers or performing on site repairs. Potential applications include: wireless approval of purchase requisitions, mobile check-in within hospitals

and hotels, and wireless dispatch and reporting for field service workers.

Is data collection costly or difficult?

Wireless devices can lower the cost, effort and/or risk of capturing and transmitting data from remote locations. For example, utilities use wireless meter readers to eliminate the cost and inefficiencies of home visits, and pharmaceutical companies are

experimenting with devices to monitor patient trials. Other possibilities include monitoring conditions in shipping containers and capturing data from offshore oil rigs.

Could process steps be eliminated by moving a function closer to the customer?

The ability to provide data where needed allows companies to move or eliminate process steps. For instance, allowing a field worker to calculate the bill and produce the invoice upon the completion of a service call simplifies the billing process, shortens collection cycle times and increases customer satisfaction.

Could immediate, on-location access to data allow the creation of a new customer service?

Offering new customer services enabled by wireless capabilities can enhance customer relationships, provide competitive differentiation and increase profits. For example, airlines increase customer convenience through wireless notification of flight delays and changes. Starbucks coffee shops hope to increase store traffic by offering wireless Internet connections to their customers.



rate notification of arrival times, better inventory control and enhanced safety for remote workers.

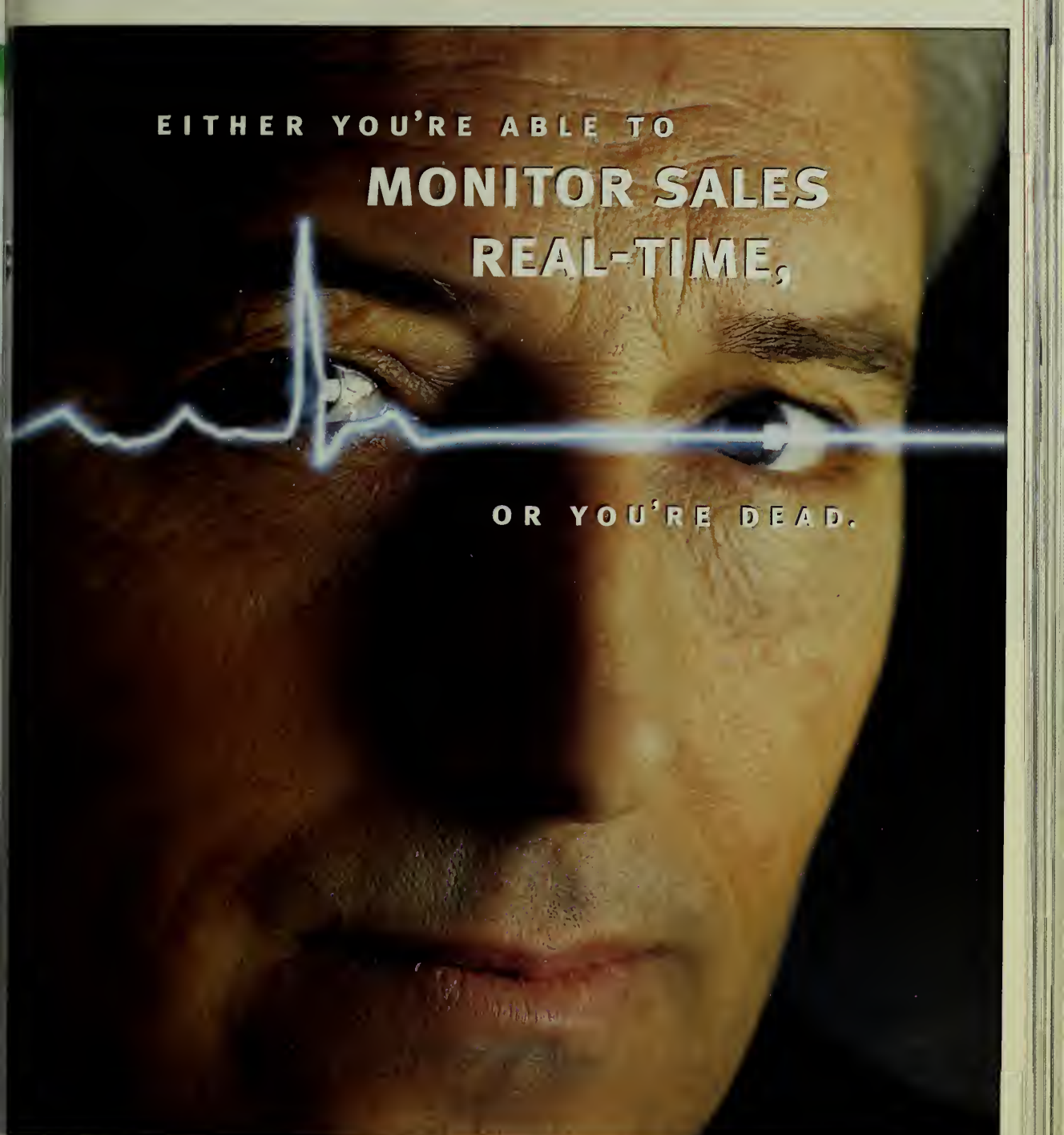
Is data captured manually for later electronic entry?

Any process that involves a mobile worker collecting data on paper forms is a potential candidate for wireless automation. A wireless application can increase the speed and

How to select the right type of wireless solution

A complete wireless solution will draw items from four categories of architectural components: information infrastructure, wireless networks, client devices and wireless applications. The **information infrastructure** consists of the backend applications, databases, voice systems, e-mail systems, middleware, and other components needed to support a wireless solution. **Wireless networks** serve as the conduit, or transport mechanism, between devices or between devices and traditional wired networks (corporate networks, the Internet, etc.). These net-

works vary widely in cost, coverage and transmission rates, and include options such as infrared, Bluetooth, WLAN, cellular telephony and satellites. The most visible component of a wireless solution, **client devices** include smart phones, pagers, personal digital assistants (PDAs), Pocket PCs, and special purpose units for scanning, bar coding and credit card reading. **Wireless applications** supply the business functionality behind the wireless solution. These applications may be "off-the-shelf" packages, custom developed, or "repurposed" from existing web applications.



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Wireless Technology

Behind these components is a supporting infrastructure of tools, processes and service provider relationships that handle the implementation, roll-out and long-term operation of the wireless solution.

To the uninitiated, selecting the right wireless solution requires navigating a complex and confusing maze of options and solution providers. The magnitude of capabilities, choices and limitations of wireless components preclude the creation of a "one size fits all" wireless solution applicable to any business requirement. An architecture that works perfectly in one place will be hopelessly inadequate in another. For example, the wireless application used by UPS to track shipments and deliveries across the U.S. is vastly different from the one that lets ER

To the uninitiated, selecting the right wireless solution requires navigating a complex and confusing maze of options and solution providers.

doctors receive lab results in a hospital operator.

Key questions to ask when selecting a wireless strategy include:

Who will use the application?

The device and application needs of a harried corporate executive looking for immediate information and ease of use are very different than those of a quality assurance inspector using a forms-based system with daily synchronizing of data.

How will the application be used?

A stockbroker may require instant notification about stock price movements, while an order status application may require only periodic updates. Serving the stockbroker requires real-time processing and an always-on connection; the order status application requires only automatic hourly synching.

Where will the application be used?

The locations where the application may be used, and the areas where mobile workers may roam, influence network and connectivity options. A system for using moveable point-of-sale terminals inside a store can use a short-range wireless LAN, but an application connecting mobile workers located throughout North America will need to use a wide area terrestrial or satellite network.

What data is required?

The data source, volume and confidentiality requirements of a wireless application affect everything from application integration and data security to transmission bandwidths. For example, a field service worker looking up customer repair records will need access to information contained within various back-office customer and support databases.

The Wireless Decision Process

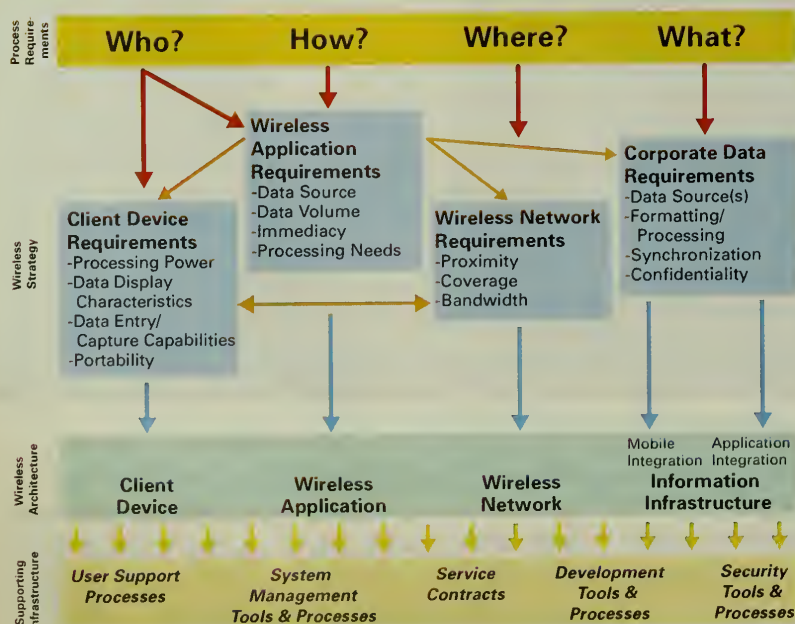


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Wireless Technology

How to overcome wireless issues and constraints

Fear of wireless technology issues and constraints causes many companies to unnecessarily delay their forays into the wireless world. Although wireless technology has yet to reach the levels of maturity, standardization and support found in other information technologies, corporations such as FedEx and UPS have used wireless solutions productively for years. Current wireless capabilities are sufficient to handle many practical applications, and wireless constraints can often be overcome through creative design.

Three major categories of constraints impact wireless applications: evolving, inherent and environmental.

Evolving constraints

Some areas of concern such as standards, bandwidth, coverage, security and support tools will decline over time as wireless software and hardware capabilities advance. For example, the throughput of short and wide area wireless networks continues to improve, and the arrival of 3G cellular networks will provide high-speed data exchange across a wide geographic area. Similarly, coverage is improving as wireless network operators continue to add infrastructure. In the mean-

time, handle these constraints by targeting application functions that can work within current limitations. Applications such as stock alerts, e-mail and instant messaging are already feasible. Techniques such as extracting and summarizing data before pushing it to a wireless device allow the exchange of high-value information, and sync-and-go applications avoid coverage and bandwidth constraints.

Inherent constraints

Constraints such as device size, display limitations and data entry capabilities, result from the demand for small, portable devices. A typical mobile device will never support the robust applications found on a desktop.

Display size and resolution determine the type of information that can be presented effectively. Keyboard size or handwriting recognition schemes direct the types of interactions possible. Memory and processing power affect the architecture of the application. Size, weight and useful battery life affect the portability and convenience of the device. Overcome inherent constraints by designing around them. For example, appli-



cations can use numbered menus or forms to minimize data entry, and intelligent partitioning of functionality between the device and an application server can circumvent processing and memory constraints.

Environmental issues

Depending on the processes the support, wireless solutions may have to handle sub-optimal conditions such as poor lighting, rough

conditions, extreme temperatures and high rates of device theft and loss. Security is an acute concern for many wireless applications. Wireless data, traveling over open airwaves, is easily intercepted. Environmental conditions are addressable through a full understanding of who will use the application and how and where it will be used. Security can be enhanced using a combination of techniques, from cryptography to authentication servers, to virtual private networks. Adverse work conditions can be addressed through proper device and accessory selection such as using ear pieces for noisy locations and backlit displays for dim lighting conditions.

How to get assistance

Hundreds of solutions providers, telecommunications companies, equipment makers and services providers have mobile and wireless offerings, and the list is growing daily. Focusing on the business and technology needs of the processes you wish to address will help narrow your search for help. This section describes the categories of vendors offering mobile/wireless products or services. Every wireless solution will likely combine elements from each

category. Note that many vendors offerings go beyond a single category. For instance, Nokia offers mobile telephones, wireless LAN products and wireless voice service.

Another example of a multi-category provider is Agilent, which offers a broad range of innovative design and test products, integrated solutions and services to support everything from mobile appliances to base stations. A leader in the support of next genera-

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Wireless Technology

tion wireless solutions, Agilent's products and services cover 3G design and test, Bluetooth design and test, mobile radio/cellular PCS test, network planning and design, base station installation and maintenance, network management, network optimization and network engineering services.

Integrators

Partnering with a reputable integrator gives a broad understanding of available technologies and a wealth of practical experience in design and deployment. Consulting assistance is offered by big integrators such as IBM and Cap Gemini Ernst & Young, mobile consulting firms and wireless specialists. ASPs often offer consulting services to implement and integrate their products, and e-business services firms are attempting to diversify by offering wireless design and implementation capabilities. The ideal partner will have experience in the specific applications and technologies that support your desired solution, strong expertise in project management, and follow user-centered design principles. Example integrators

include: Aether Systems, ArcStream Solutions, Mobilicity, Stellcom and Wireless Knowledge.

Application Software

Although companies can create their own custom applications, a growing variety of prepackaged software applications are available to meet mobile/wireless needs. Application software options run the gamut from personal productivity tools operating on PDAs to full suite solutions that support many types of business activities. Example providers include Airlink Communications, Antenna Software, 724 Solutions, Siebel, Summit Health Services, Thinqe, and Viryanet.

Device Makers

Although their capabilities are rapidly converging, client devices tend to be selected by category. Smart phone providers include Ericsson and Nokia. Compaq and Hewlett-Packard offer Pocket PCs. Palm, Handspring and Sony offer PDAs. Motorola and Research in Motion offer pagers and email devices. Symbol Technologies, Intermec and Apriva offer special-purpose devices.

Software Infrastructure

Software infrastructure includes the development tools, security software, middleware and utilities needed to support a wireless solution. Example providers include Aether Systems, AvantGo, Certicom, F-Secure, IBM, MobileQ and Vfone.

Wireless Equipment Makers

This category of vendors provide hardware and system software for wireless LANs and supporting component such as wireless modems, cards, GPS locators and test equipment. Example wireless equipment makers include Airlink Communications, Cisco, Intel, Motorola and Enfora.

Network Operators

Wireless solutions that rely on wide area networks or cellular telephony will purchase voice, data, Internet and/or e-mail services from carriers such as Nextel, AT&T Wireless, Cingular, and Sprint PCS or Wireless Internet Service Providers (WISPs) such as Metricom, Motient, Omnisys and Go America.

It's time to start!

Wireless technologies give us the opportunity to reshape the way we work to improve service, safety, efficiency and profitability. By focusing on our highest value business processes, we can reap significant benefits now, while gaining valuable experience to better exploit future technology capabilities. Selecting the best candidate processes first, we can eliminate many of the seemingly overwhelming technology options before us. Finding the right partners to guide and support our initiatives helps us to avoid pitfalls and gain full advantage from our solution. Powerful new opportunities await us. Wireless technology is ready to go.

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SAVAGED BY THE SLOWDOWN

How families are coping—or not—with the fallout

Until the downturn, 40-year-old Steve Jackson's blood pressure was an ultralow 105 over 60. After surviving a plane crash in 1984, in which his United Air Lines 727 hit a radio tower on takeoff and ripped the fuselage under his seat, he nonchalantly boarded the next available flight. Seemingly unflappable, his family and friends thought of him as a cool-hand Luke.

Until the night of Feb. 15, when Jackson stared at the news on the com-

puter screen in his cluttered Chapel Hill office and couldn't believe what he saw. Jackson, a university research coordinator for Nortel Networks Corp., had always thought of his Nortel options as a reward for the lean years when he and his wife lived in a two-window dump so dark it killed the plants. But news that Nortel would miss earnings was sending the stock into a tailspin, one that ultimately wiped out his one-time, million-dollar fortune and left him with a \$400,000 tax bill on money he

would never see. Turns out that hanging on to the shares after he exercised the options instead of selling, Jackson had triggered the alternative minimum tax. That move, in turn, ended up destroying his kids' college savings and the family's net worth.

At first, Jackson had trouble keeping food down. Then he couldn't sleep. Acne sprouted all over his face. His doctor prescribed Valium, which Jackson says he ate "like M&Ms." To cope with the debt, he took a second mortgage on the

Layoffs and heavy debt loads are hitting families

"THIS PROBLEM CONSUMES ME"

Steve Jackson took a second job after \$1 million in Nortel stock options turned into a \$400,000 tax bill

house, which he says he'll be lucky to keep, and another job as an electrician's assistant on the night shift, paying \$20 an hour. "It's like Kafka," says Jackson, who worries when his phone rings that it's a layoff call. "Work-family balance? I have no balance. From the moment I wake up till I fall asleep, this problem consumes me."

The downturn has done plenty of damage, ravaging market caps, decimating earnings, and extinguishing all sorts of entrepreneurial dreams. Less visible has been the slowdown's effect on families. As companies gear up for what is predicted to be a third round of job cuts this fall, economists say unemployment could rise to 5% by early next year.

"FANTASY WORLD." Not that those who are still employed are without their worries. Businesses across the country are saddling their reduced ranks with bigger workloads, causing stress levels to spike beyond their boom-time levels. They are also cutting bonuses, which will likely leave many families strapped, having financed their luxury lifestyles on the extra compensation. Already, some boomers are angry about being unable to afford retirement, while many elderly are disappointed about derailed plans to move into posh, concierge-equipped retirement communities. These downbeat expectations for the near term appear to be catching on with consumers, who sent the Conference Board's confidence gauge down two points in August

to a two-month low. "Almost any market indicator you look at points to significant and increasing amounts of stress in households," says Mark M. Zandi, chief economist at researcher Economy.com. "And I get no sense that it's going to come to an end anytime soon."

Employee assistance and outplacement professionals say this dampened outlook, coupled with dwindling severance packages, are causing new and disturbing tensions among employees and their families, especially now that Cor-

porate America's paternalism has largely vanished. "The downturn is now hitting them very hard," says Richard A. Chaifetz, chairman and CEO of Compsych, the world's largest privately held employee assistance firm, whose clients include American Express, J.P. Morgan, and Krispy Kreme.

Indeed, Chaifetz says Compsych is receiving record levels of calls for help from employees and their families. Since the downturn, counselors say they have seen a marked increase in "crisis calls" involving problems such as online affairs, addictions in adolescents, and spousal abuse (which counselors say is occurring more and more against men). "People feel like they had the rug pulled out from under them," says Chaifetz. "They were living in a fantasy world."

Now, they're finding out how harsh reality can be. Sure, plenty of families stashed it away during the boom, protecting themselves from the economic whiplash. Others, who haven't suffered a layoff or a big economic reversal, are humming along just fine. In fact, these sorts of families have helped support what until recently has been a surprisingly upbeat mood among consumers. But Economy.com's Zandi warns that the number of families feeling the strain may well grow over the coming months. That's largely because Americans are sitting on huge piles of debt. Delinquencies on car loans and credit cards are at or near record levels, as are those on mortgages for lower-income homeowners. Household debt service has also hit an all-time high, along with personal bankruptcies (charts). And for those who still have jobs, their incomes, hours, and bonuses, like those of executives at Ford Motor Co. and

Sun Microsystems Inc., are being cut.

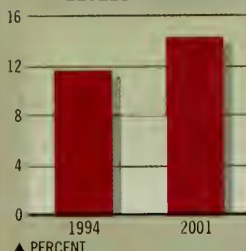
These financial troubles are not being lost on companies. Human resource professionals figure that when workers worry about family finances, they waste 13% of the workday on calling creditors and other distractions. Money woes also lead to medical problems, lower

productivity, more absenteeism, and accidents. Indeed, research shows that family members who survive a layoff face workplaces that are more stressful, political, and cutthroat than before the downsizing, leaving them with even less time for family. Some employee assistance firms have added financial counseling, as well as survivor seminars, to their offerings to help workers cope.

Nowhere is that help needed more than in the Bay Area, where the jobless rate has jumped from 1.7% in January to a recent 4.7%. During the boom, the lines at Frankie Johnnie & Luigi's in Mountain View, Calif., were two blocks long, filled with dot-commers celebrating stock prices over the sausage bread and salami stromboli. Today, only a small clump waits to get in. Instead, the long lines are forming across the railroad tracks at the non-profit food bank, Community Services Agency. **PRIORITIES.** Each morning, about 75 or so laid-off high-tech workers line up for the 10 a.m. opening, when they can get bread, butter, and milk—when it's available. Last year, most of the agency's clients were low-income workers who showed up in their fast-food uniforms. Today, it's

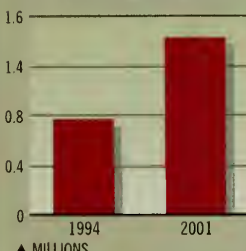
DOWN AND OUT IN THE DOWNTURN

HOUSEHOLDS ARE TAKING ON RECORD LEVELS OF DEBT...



▲ PERCENT
*SHARE OF AFTER-TAX INCOME DEVOTED TO PRINCIPAL AND INTEREST ON MORTGAGE AND CONSUMER INSTALLMENT DEBT

...AND PERSONAL BANKRUPTCIES ARE AT ALL-TIME HIGHS...



...CAUSING WORKERS AND THEIR FAMILIES TO FEEL DESPERATE FOR HELP

Increase in calls this year to employee-assistance professionals about

Financial trouble	60%
Legal problems	25%
Marital and relationship turmoil	20%

Data: Economy.com, Federal Reserve, U.S. District Courts, American Bankers Assn., Compsych

laid-off dot-commers in khakis, especially single parents and those fresh out of college. "The kind of people we're seeing has drastically changed," says the agency's executive director, Tom Myers.

Some who have suffered huge reversals are finding the crisis can help them

rd—and ratcheting up stress levels even for jobholders

In Mountain View, Calif., khaki-clad victims of the dot-com boom

set new priorities, like the ex-dot-com CEO who postponed having kids during the boom, only to realize now that she really does want a family, even though she and her husband lost their millions and can barely afford the rent. But mostly, the newly jobless and suddenly

illies he sees to those he counseled in the 1980s through the Oklahoma oil crisis, when the suicide rate got so high the state started a gun-giveback program. "People held on for a couple of months in Oklahoma before they crashed and burned," Thomas says. "It's déjà vu here."

ANGRY AND AFRAID. Group member Ivan Temes, who has had a 30-year career in Silicon Valley in customer support at stalwarts such as Levi Strauss & Co. and Apple Computer Inc., has no trouble believing that. Temes has been laid off before, but the most recent downsizing, from Internet privacy company Privada Inc., was the worst, coming with no warning, no benefits, and no severance. His wife is angry and afraid, especially since the family has run through its savings and Temes recently called about food stamps. Their 6-year-old son, Joshua, also feels the financial



Special Report

WORK & FAMILY

unwealthy are distressed, and they are flocking to newly formed support groups, like Transitions at Mountain View's St. Timothy's Episcopal Church. Members participate in role-playing exercises, where some of the downturn-induced family pressures are vented and worked through. Leading the sessions is James Thomas, a minister and Jungian analyst who likens the pain of the fam-

LOOK WHO'S BAREFOOT IN THE KITCHEN

You could say Doug Wilson is the sultan of savvy dining in Dallas. The 35-year-old can get his family of five in and out of Furr's Cafeteria—where he and his wife lean toward the meat bar and his kids prefer the seven colors of Jell-O—for under \$30. The deal he's got at Marshall's BBQ and Souper Salads is even better: \$20. Avoiding places like Olive Garden and TGI Friday's, with their \$45 tabs, is one of the many ways Wilson and his wife, Lisa, survive on just one annual paycheck of \$40,000.

Her paycheck, that is. Wilson used to spend his days soaked in sweat managing road repavings in the 110-degree Texas sun. Now, he does the housework, runs the errands, and scours the city for bargains in his '86 Ford LTD. "This is the hardest job I've ever had," Wilson says.

In many ways, you could say Wilson has traded places with June Cleaver, becoming one of a new and growing breed of housewife—the househusband. In fact, the

number of children living with stay-at-home dads has jumped 70% since 1990, to 1.7 million, according to Census data. "These are dads who have committed to leaving their life for four to five years," says family researcher Robert Frank, a psychology professor at Oakton Community College, in Des Plaines, Ill., who studies at-home dads.

Some of these fathers, like former Simpata Inc. CEO Jeff Simon, were fired from working 12-hour days and missed

spending time with their kids. Others like former Dell Computer Corp. sales manager Justin Espinosa, decided to stay home with their children after they got laid off, sending their wives into the workforce, only to experience marital strife as a result of the swap. The latter are those like Wilson, whose wife's earnings began to outstrip his, causing him to question the value of spending a month on a germ-filled child-care facility when he could raise his kids himself.

Trailing husbands, however, do not follow their globe-trotting executive wives as also part of the trend. "Five years ago, if you were recruiting a former executive, you always had to take into consideration the husband's career, who we could not induce him to," says one Silicon Valley's top executive hunters, Russell R. Associates Inc.'s Bob Stein, whose physician husband has primary responsibility for the kids. "Now, I don't even think about it anymore."

Because their own numbers are still so low, the increase in stay-at-home dads hardly re-



HOME BODY

Wilson gave up his road-paving job to look after his kids full-time

up at a food bank each day for bread, butter, and milk



fear. Recently, when Temes was on the way out the door, he recounts, he needed some change and asked Joshua for a quarter. Running out of his room, Joshua waved a bill in his hand, shouting excitedly, "Here, Daddy—here's a dollar." Says Temes: "He gets what is going on."

Temes is hoping his next job will last long enough for the family to regain its footing. But with hiring-and-firing frenzies part of the new employment landscape, getting a new job doesn't mean the end of uncertainty. No one knows that better than George de-Walder, a specialty-materials manager in Mocksville, N.C. The 55-year-old has been a casualty of serial layoffs, losing 9 jobs in 10 years, a

volatility he says nearly ruined his relationship with his 23-year-old son. He also blames the downsizings for playing a role in the end of his 28-year marriage to a woman he still loves but who couldn't take the roller coaster. "I wouldn't wish her on me, either," he says. It didn't make things any easier, he adds, that she worked for SAS Institute—a company that never lays off workers. "In all my times of job hunting, I've never seen it this bad," de-Walder says. Lately, he says, he has begun to ask himself: What's the point?

Others, who made and lost fortunes, who got and lost promotions, who were and then weren't CEOs, are asking themselves the same question. For many families in the downturn, all the euphoria on the way up is being followed by equal doses of pain on the way down.

*By Michelle Conlin
in New York*

HELPING HAND Minister Jim Thomas runs a support group for the jobless in Silicon Valley

thers have suddenly become co-
the home, sharing equal responsi-
or child rearing with their wives.
st households, working women are
ones doing the second shift at
says Frank. But, more and more,
hers note, the roles are starting to
evident in the increase in male
ves working compressed weeks so
n have more time with children, in
rkers who are taking responsibility
laytime child
d in dads work-
n home so they
closer to their
rank estimates
a total number
with primary
ability for chil-
dual-earner

**MR.
MOM**

olds has jumped 25% since the
90s to 2.5 million.
UT TIME. Another surprising sta-
children are actually spending
me with their parents than they
0 years ago, according to several
The enhanced participation of
child-rearing is the biggest rea-
sides the falling birth rate. One
time diary study, conducted by
L. Hofferth and John Sandberg
University of Michigan's Institute
Research, found that despite a
increase in the number of dual-
families, children under 13 with
g parents were spending an aver-
four hours more a week with
others and almost six hours more
with their fathers than they

were in 1981. The increase, notes Purdue University's professor of family studies, Shelley M. MacDermid, stems in part from discomfort parents have in sending kids out to play unsupervised. In fact, the study found that children's time with mothers and fathers in two-parent families increased so much that it washed out any decrease of time due to the mother's outside employment.

If parents are spending more time

*The number of wives outearning
their husbands is growing...*

1990	1999*
8,221,000	10,548,000

*Most recent year for which data is available

with their kids, then what gives? Housework, according to Suzanne M. Bianchi, professor of sociology at the University of Maryland. Bianchi found that both working and at-home moms spend about half the time on household chores that they did in the 1960s, thanks to take-out meals, hired housekeepers, and wrinkle-free clothes. Meanwhile, men's time on household duties during the same period has doubled, so that they are now doing fully one-third of housework.

Of course, the current economic downturn is playing a role in men's increased involvement. Often, though, these dads say their time at home adds to the family stress level. As much as wives want their husbands to be involved, the role reversal can be difficult, forcing them to

relinquish control of the home. Husbands, on the other hand, have to struggle against the ingrained expectation of being the bread winner. Espinosa, the Dell manager, thrived in his career in service operations there. But the 28-year-old often worked 60 hours a week. He was worried about the way he often left the house before his three kids even woke up. So when he got laid off in May, he decided to make the scariest decision

*...contributing to the rising number of
children living with stay-at-home dads*

1990	2000
1 million	1.7 million

Data: Bureau of Labor Statistics, Census data

of his career—putting it on the shelf for the summer. His wife went to work, for the first time in their marriage, at a local Internet company. "The stress between couples is tremendous," he says. "Two sets of our friends are separated right now, and the layoff has had a lot to do with it," Espinosa says. He's now looking for a new job.

Even if couples hash things out in their relationship, as the Espinosas have, trading places can bring on judgments from the outside world. Many stay-at-home dads complain about the conversational snubs and weird stares they get at playgrounds and school yards. More and more, though, these caregiver fathers are likely to become a more familiar sight.

By Michelle Conlin in New York

MANAGEMENT

HIS OWN MAN

Is there room for improvement at General Electric after Welch? Jeff Immelt thinks so



Jeffrey R. Immelt is sitting in a company boardroom wearing a crisp dark suit. Problem is, he donned the tie only to meet with top brass from Wal-Mart Stores Inc., but they all dressed down to meet the usually casual executive. And he couldn't meet in his new corner office. It's full of workers removing 20 years of John F. Welch's stuff. But Immelt does not look the least bit bothered, though he's just days away from taking over the \$130-billion-a-year General Electric

Co. from the legendary Welch. Instead, as he leans back in his chair downing pretzels and Diet Coke, he's got the easy air of someone who takes success for granted. "I've never measured my self-worth by whether or not I got this job," he says.

Heroic words for someone who's following the most praised CEO of his generation. No one had to tell this 6-foot, 4-inch college jock that he had big shoes to fill when Welch stepped down Sept. 7. The outgoing chief may barely reach to

the new CEO's shoulders, but there's little doubt that Welch has been a tough act to follow. Michael Jordan of American business—execs—even with GE's failed \$45-billion takeover of Honeywell International Inc. and a government decision to make pay \$460 million to clean up PCBs in the Hudson River. Shareholders loved him. Insiders often feared him. But Immelt doesn't see himself as replacing Jack Welch. He's here to run General Electric, and, frankly, he thinks the world's most valuable company has lots of room to improve.

"When Jack calls, you shiver," says one senior General Electric executive.

AT EASE: Immelt's management style is quite different from Welch's

tent on speeding up the spread of technology throughout the company and turning the Research & Development Center into an intellectual hothouse. He wants to overhaul GE's relationship with its customers. He's planning to make major acquisitions in strong units such as medical systems, power systems, and aircraft engines while downplaying the company's slower-growing divisions—but brushing aside rumors that he'll kick them off the island. In short, he promises a GE that looks “completely different in three or four years,” but he doesn't need a Next Big Thing to do it.

HEAD CHEERLEADER. Meeting Jeff Immelt, there's a sense that this is a guy who wakes up after his five hours of sleep, looks in the mirror and says, “Damn, you're good.” It's confidence, not hubris. If anything, he shows an interest in others that could put Dale Carnegie to shame. This isn't a scrappy, stuttering kid from outside Boston with something to prove, like Welch. Winning is part of Immelt's life script. He's the star athlete, the Ivy Leaguer, the fraternity president, a guy so likeable and so decent that Dartmouth College gave him an award for character—a distinction that Immelt jokes was given to whoever could chug the most beer. He even laughs that seven years ago Welch threatened to give him the boot if he didn't get prices up at the plastics unit where he was running half the business. He did, he says, and the experience made him only stronger. So does Welch intimidate him? Please. He loves the man. Says GE Director Kenneth Langone, co-founder of Home Depot Inc.: “There's no bowing in that relationship.”

There's also no doubt that after nine months of helping run GE as chairman-elect while Welch delayed his retirement to handle the Honeywell deal, the two men have different management styles. Where Welch poked, prodded, and deployed his troops as if they were heading off to war, Immelt cheers them on as if they're the home team before a big game. “There was a bit of that fear factor with Jack,” says David L. Calhoun, CEO and president of GE Aircraft Engines. Another senior manager is blunt: “When Jack calls, you shiver. When Jeff calls, you smile.”

Many GE types revered Chairman Jack. They adore Chairman Jeff. He's the dude in the next dorm room. The guy who will carry one of your ankle weights if you carry the other, as he did for former colleague and neighbor Bob Gariano as long as the puffing executive agreed to finish their morning jog. GE Director Shelly Lazarus, chairwoman and CEO of Ogilvy & Mather Worldwide, uses terms such as “self-efficacy,” “great humanity,” and “quiet strength” to describe the new leader. “Jeff doesn't use the I-word hardly at all,” she says, instead it's “we” and “the team.” Had Welch staged a beauty contest instead of a horse race for the top spot, Immelt would have come away with Mr. Congeniality at the very least.

The question, of course, is whether a nice guy can deliver results. For all of the grumbling about Welch's blistering in-your-face manner, it was clear to every GE employee that you put up or you perished on the career ladder. Strike that. You were out on your ass. Some observers fret that Jeff may be too nice to run a far-flung empire like GE. When introducing Immelt as the new CEO of the medical-systems unit almost five years ago, Welch even joked that he was soft. Immelt then proceeded to boost sales at the unit from \$4 billion to \$6 billion in his first two years through aggressive acquisitions, increased customer service, and pushing his top people to produce better results. Yoshiaki Fujimori, who managed the unit's Asia region under Immelt and now heads GE Plastics, argues that his boss's manner can be deceiving. “He sounds like a nice guy, and weaker people might think that means they don't have to deliver as much. That's wrong.”

Still, Immelt is the very soul of consideration—going out of his way, for example, to be decent to GE's least-sexy units. Appliances and lighting are two old-line businesses whose growth tends to lumber along in the low single digits behind higher-margin, service-intensive siblings such as power systems, medical systems, and aircraft engines. Analysts like to debate which one is likely to be dumped first. Even Welch said he tried to sell appliances at one point. Immelt will say only that no more businesses will be added to those units, and he praises them as good places to generate cash, train people, and build the brand. He won't even admit that



rove—by using technology better, getting closer to customers, diversifying as mix of businesses, and reducing the cut of white guys at the top.

In fact, the new chairman and chief executive is plotting GE's future with the confidence of a seasoned veteran. Immelt, 45, promises to deliver consistent earnings growth through the ugliest downturn in years—although he admits that if the economy gets worse, “there [are] scenarios in which GE earnings growth] would be very tough.” He's in-

electric executive. “When Jeff calls, you smile”

The Corporation

they're lower on the priority list. It's like trying to pick between children, he says: He loves them all.

Immelt, however, knows better than most that some kids rise to the top. Take GE Capital, the roaring financial services unit that now accounts for 40% of overall earnings and an even higher portion of revenue. Left unchecked, it could easily overtake the manufacturing side, making GE too reliant on often-volatile financial revenues and hurting its vaunted price-earnings multiple. As Keith S. Sherin, GE's chief financial officer, notes: "If it starts to deliver over 50% of our earnings, that might have an impact on our multiple." Aware of that, Immelt says big industrial acquisitions will help him keep the capital unit to under 45% of GE earnings for at least the next three years.

away. It's enough to make a guy known for knit shirts and no socks dig out a tie. What bowled over Delta Air Lines Inc. Chairman Leo F. Mullin wasn't Immelt's offer to fly down for dinner, something Welch never did. It was getting phoned during Delta's recent labor woes. "He just called to say he thought I was doing well," marvels Mullin. "That meant a lot to me."

DIVERSITY DRIVE. Immelt wants that personal touch to permeate GE's sales force. On the best days, he says, the salespeople now spend 30% of their time in front of the customer. Under Immelt, they'll be freed up to devote 70% or 80% of their days to customers, anticipating their needs and making sure that GE makes them money. GE now gets 41% of its sales outside the U.S., and Immelt believes that to get to the customers, GE

opportunities to rise to the top ranks something that rarely seemed to happen during Welch's era.

Internally, Immelt is also on a drive to enlist his fiercely competitive colleagues on his side. He has brought in friend, Dallas-based management guru Ram Charan, to work with him in curbing General Electric's elite and consolidating their support. As Immelt explains, the transition is a time when such executives need to be engaged. "That group of leaders can't think the window opened and closed without the chance to have a voice, to shape the future, to be involved." And why Charan? "One thing I get with Ram is plainity; he doesn't filter it," says Immelt, all too aware that people like to be the top guy with kid gloves.

One message that he's keen to bro-

BUILDING TEAM JEFF *Some of the key players in GE's post-Welch regime*

THE THREE WISE MEN



DENNIS D. DAMMERMAN, 55, chairman, GE Capital. Hired Immelt out of college. Now runs GE's roaring finance arm.

GARY L. ROGERS, 56, vice-chairman of GE. Immelt's boss at Appliances & Plastics. Tough and obsessed with costs. Neutron Gary?

BOB WRIGHT, 58, chairman and CEO, NBC. Helping Immelt understand the broadcast business, GE's glamorous cash cow.

Then again, the multiple isn't looking so stellar these days. GE's stock is down almost one-third from its 52-week high, to about \$41, even as the company continues to churn out yet more quarters of 15% earnings growth at a time when many rivals have tanked. That's still roughly 30 times earnings, down from 51, while financial institutions tend to trade around 20 times earnings. But is it a reflection on Immelt that the so-called Welch premium doesn't seem to be boosting the stock anymore? He won't speculate. Hey, the world will soon see how Jeff Immelt makes his mark.

His priority is people, and the ones who don't get enough attention from GE, in his view, are the customers. He has spent the past nine months crisscrossing the globe to connect with key clients. He's passionate about the big ones, the little ones, the ones that got

DAVID L. CALHOUN, 44, president and CEO, GE Aircraft Engines. Once considered a rival to replace Welch; known as a sharp global thinker.

JOHN G. RICE, 44, president and CEO, GE Power Systems. Worked with Immelt at GE Plastics and now heads a red-hot unit.



JOSEPH M. HOGAN, 44, president and CEO, GE Medical Systems. "Looks like a kid," says one insider. Seen as innovative and strategic.

must become more like them—especially in the top ranks. That means more Chinese, more Indians, more blacks, more women. In short, not just white men.

Diversity, in fact, is where many think Immelt may make his greatest immediate impact. Fujimori of Japan is the first foreign national to head a GE unit, and in a recent speech in Tokyo, Immelt promised there'll be "many more Fujis to come." He says he was "haunted" by a newspaper article that ran with pictures of GE's senior staff. Today, of 31 top executives, there is one black man and not a single female. Immelt, who moved quickly to diversify GE Medical Systems, promises to do the same with the rest of GE. He thinks that it will be easy, noting that women and minorities at lower levels now run GE businesses reaping \$30 billion in annual sales. The key is to give them op-

JEFF'S PALS

FACES TO WATCH

SCOTT C. DONNELLY, 39, senior vice-president, Corporate Research & Development. Med Systems colleague and critical player, given Immelt's increasing attention to R&D.

YOSHIAKI FUJIMORI, 50, president and CEO, GE Plastics. First foreign national to run a GE unit and a sign Immelt wants diversity at the top.



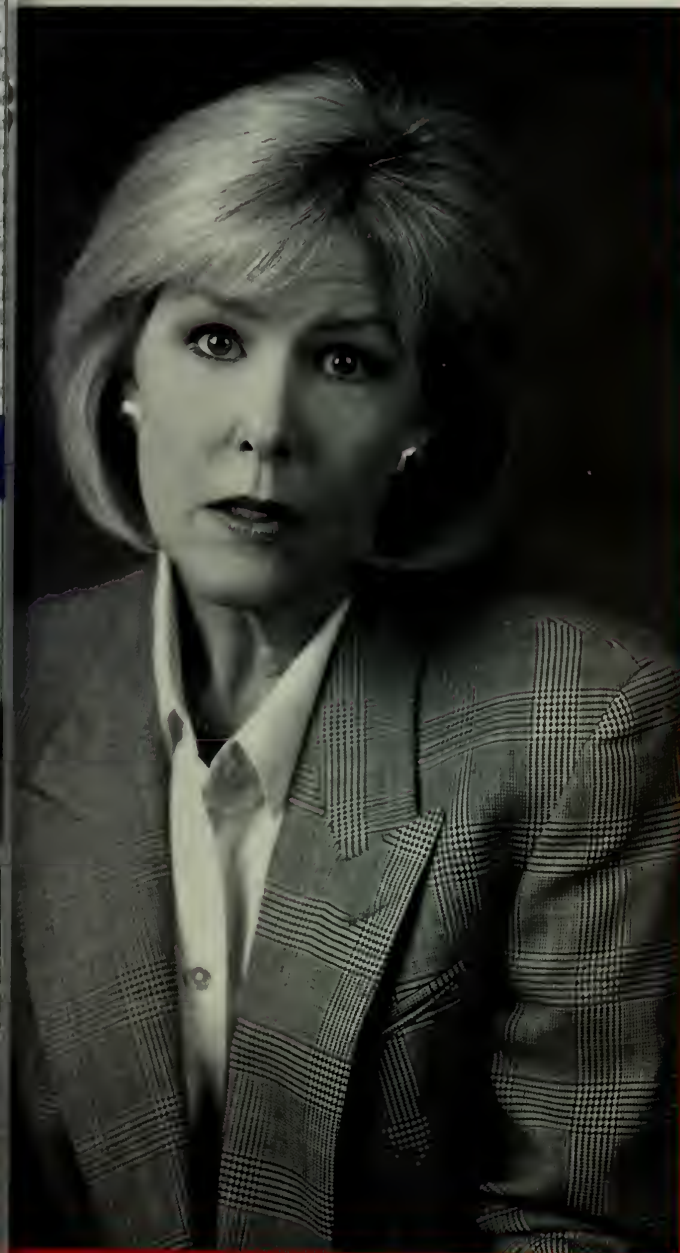
GARY M. REINER, 47, chief information officer. His star is rising with GE's growing focus on technology.

cast both inside and outside GE is the like Welch, he will be skeptical and digging and tough when the times demand. In his view, the beauty of GE is consequence. Good is good, and bad is bad. Standards are absolute. Effort is encouraged, but results are what count. Anyone who doesn't deliver is out. Immelt wants to make the place leaner and meaner—although he won't say whether that means mass layoffs like those that earned Welch his much-hated title Neutron Jack.

At the very least, Immelt has been spared the task of cutting tens of thousands of jobs after a Honeywell acquisition. Nixed in July by the European Commission, the merger could have been Welch's swan song and Immelt's biggest headache. He claims to be deeply disappointed by the EC's decision, although he says "in a place like

"We need computers for the new offices by next week."

Translation: We need a miracle by next week.



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this, the disappointment lasts seven seconds." He would like to snap up some choice cuts of the company should Honeywell Chairman and CEO Lawrence Bossidy, a GE alum, decide to slice and dice it for sale.

For the time being, though, Immelt is simply happy to pick up where his celebrated boss left off. The genius of Welch, Immelt argues, was not so much how he pushed himself as how he pushed others toward new heights of excellence. Immelt calls General Electric

JEFF ON JACK



"Jack changed our lives. It doesn't mean he's perfect or that I loved him every day. He made me reach higher and further"

a bunch of ordinary people who, together, have done extraordinary things. And the reverence for Jack is "not because we're all psychos and weirdos and drinking the Kool-Aid. It's because a lot of us never thought we would do this." Today, Immelt must keep the fire going in a tough economic climate. Maybe now, Mr. Congeniality will really bare his teeth.

By Diane Brady in Fairfield, Conn.

BusinessWeek online

For a Q&A with Jeff Immelt, go to the Sept. 17 issue online at www.businessweek.com.

MANAGEMENT

MY THOUSAND HOURS WITH JACK WELCH

What it was like to collaborate on the GE chief's memoir

BY JOHN A. BYRNE

It was a late August night, and I had just walked through the door of Jack Welch's guest house in Nantucket after a long night at a charity dinner. The phone rang. It was Jack, insisting I take a look outside. The moment I stepped onto the deck, his raspy voice boomed through the darkness. "Look up!" he shouted from the balcony of his summer home. "Isn't it incredible?"

The starry sky was brilliant—but the greater impression was left by Jack himself. He seemed as genuinely thrilled as a kid with an unlimited allowance at FAO Schwarz. Over the next year, as Jack's collaborator on his memoir, I'd see up close his remarkable zest for life, his passion for living every moment to the fullest.

It was the most grueling and most exhilarating experience of my professional life. I'd eventually log in well over 1,000 hours with Jack, often sitting side by side, at all times of the day and night, over pizza and beer, bowls of microwave popcorn, frozen yogurt, and enough Bordeaux to stock a modest wine cellar. Our sessions together were thoughtful, fun, engaging, and intense. The final five months we worked seven days a week, through every weekend. Jack conceded that he had never worked so hard in his life. I think he even forgot how to play golf.

OPEN DOOR. Jack asked me to be his collaborator during the summer of 2000. I jumped at the invite. A few years earlier I had spent four months reporting and writing a cover story on him for *BusinessWeek*. Jack was remarkably generous. He didn't open the door. He took the door off its hinges. He shared private letters, conversations, and confidences. I was at work on the book for

only a couple of months when I received an unexpected phone call from Jack on Saturday morning. "You've got to come down here to New York right now. We're trying to buy Honeywell, and it's crazy. It's so much fun. Hurry up."

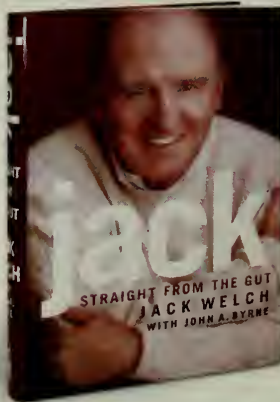
A few months later I was on a General Electric Co. corporate jet heading

home from Brussels after a disappointing meeting between Jack and the European Competition Commissioner Mario Monti. Other leaders might have been crushed. Not Jack. He was already 10 steps ahead, putting together a new strategy.

Over the course of the project, I ventured to Jack's hometown of Salem, Mass., prayed in the same pew at the Church of St. Thomas the Apostle as his mother when he served as an altar boy. I visited his childhood home on 15 Love St. and walked the ground where he fell in love with the game as a 12-year-old caddy. I interviewed friends and relatives, mentors, colleagues—even his first wife.

What struck me most about Jack was his extraordinary ability to show boundless, unrelenting toughness and sincere affection for the people in his orbit—often at the same moment. No one who has worked closely with Jack has been spared either a swift kick or an enveloping hug. Jack is simply more impatient and more demanding than anyone could possibly imagine. He is also smarter and more endearing.

Early on, I sat down with Bill Lane, who has helped Jack put together his annual report letters. Lane asked me if I knew what I had gotten myself into. He told me that one of Jack's letters had gone through 100 drafts when it was pulled off the press for still more alterations because Jack didn't like



WELCH SAID HE'D NEVER WORKED AS HARD AS ON THE BOOK



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"You've got to come down here to New York.... We're trying to buy Honeywell, and it's crazy. It's so much fun"

the "flow" of the words.

I was forewarned, but nothing could prepare me for what was to come. I struggled to get Jack to dig deeply into his past, but he's a guy who lives for the moment. There were also times when we fought over what to cut and what to leave in. In general, he was tough on himself—but drew a line when it came to hurting someone else's feelings or reputation. With one or two exceptions, this is not a book about settling scores or dishing dirt.

It's an understatement to say that Jack sweats the details. He lives them over and over again, and he makes you think two, three, four times and more about them. We went over every draft, word for word, comma for comma. We argued over the use of a dash in a sentence. Once, Jack grabbed my arm, looked me in the eye and said: "You're going to mess this up, aren't you?"

LONG REACH. I laughed. What else could I do? It was Jack being Jack. Only months before his retirement, he was still suggesting changes to NBC's prime-time schedule and "approving" storyboards for a TV commercial for a new GE refrigerator. "Approving," by the way, doesn't quite capture the mood of those meetings. He was as actively and passionately involved as anyone else in the room. His reach was extraordinary. One afternoon, he scurried over to CNBC's studios in New Jersey to rally the staff of *Business Center* for the return of Lou Dobbs on rival CNN. When Jack came back, he was electric with excitement, pulling all kinds of levers to make sure CNBC would hold its own.

Over-the-top meddling? Not the way I saw it. His focus and obsessions make it clear that he cares. You know that what you're doing is important work. You understand it commands his complete attention. Something else happens during these moments: You don't want



BYRNE AND WELCH: Thoughtful, passionate, and intense sessions

to disappoint him. It's the most potent form of motivation on the planet.

Besides, as GE employees well know, there's just no escaping Jack Welch. At one point, I had locked myself up in near total seclusion to churn out some early drafts. I hadn't been in touch with Jack for nearly two weeks. Suddenly, up pops an e-mail on my computer. The message: "Have you disappeared? Jack." I gulped and quickly dashed off a response, letting him know how hard I was working on the manuscript. His reply came back within minutes: "I love you.... I just thought you passed away."

From the start, the goal was to create an intimate conversation between Jack and the reader, a dialogue that could easily occur at a bar over a drink. Jack insisted that there could be nothing that might be considered "pompous" or "preachy" in the book. He wanted to

address the small and big mistakes of his career, from his acquisition of Kidder Peabody to hiring Japanese employees on their ability to speak English.

There were tender moments. Jack grew mist-eyed recalling the night he washed his mother's body in a hospital room, hours before her death in 1964. He was hilarious in recounting the details of his heart attack in 1995 that led to bypass surgery (He dashed through a crowded hospital emergency room at 1 a.m., jumped on an empty gurney, and began shouting: "I'm dying! I'm dying!")

But Jack became the most animated when reflecting on the ideas that have formed the core of his management philosophy. We explored the origins of many of them, from the dictum to be No. 1 or No. 2 in every business to the concept of a "boundaryless" organization. (The word popped into his head on a beach in Barbados when a guy dressed up as Santa Claus popped out of a submarine.)

One day Jack arrived for our interview session and said plainly: "If we can't get through the first 10 years of the job next week, we stink!" We didn't make it. There were far too many revisions. Toward the end of the project, with editors breathing down our necks, we holed up every weekend in a room that looked and smelled like a college dorm to grind out the final chapters.

As Jack leaves GE in an orgy of media attention, most observers are commenting on how he made GE the most valuable corporation in the world and what his legacy will eventually be. I remember and admire most not the results but the extraordinary human being behind them.

Byrne is a senior writer who took leave of absence to write Jack: Straight from the Gut.



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**THE NEW
CROSSFIRE:
GERMAN AND
U.S. PARTS**

The midsummer sun was setting over Upper Long Lake in Bloomfield Hills, Mich., as Chrysler Group's new CEO, Dieter Zetsche, sipped wine and chatted with Detroit's elite at a fund-raiser for the United Way. Now that the German executive is a captain of U.S. industry, he receives invitations to all kinds of charity events. What made Zetsche's presence at this party so remarkable, however, was that the host was James P. Holden, the American he had replaced.

At the end of the evening, Holden cornered Zetsche on the terrace to ask some pointed questions about Chrysler's troubles. It was the first time they had spoken since November, when DaimlerChrysler CEO Jürgen E. Schrempp fired Holden after less than a year on the job and dispatched Zetsche to take over the struggling U.S. unit. As a member of DaimlerChrysler's management board, Zetsche had frequently second-guessed Holden when Chrysler's business began to sour in the summer of 2000. Now, in the most professional way possible, of course, Holden in effect said: "I told you so. Fixing Chrysler is a little more complicated than it looked, isn't it?" Zetsche didn't argue.

What could he say? Not so long ago—in 1998, say, when Daimler-Benz and Chrysler linked up—Chrysler earned more on each vehicle than any other major carmaker and it had a well-deserved reputation for eye-catching design. Today, it is bleeding money: It will lose at least \$2 billion this year, and by its own calculations probably won't make a dollar of profit until 2003. Although it offers huge discounts, Chrysler's

market share is shrinking. Since the merger, it has fallen from 16.2%

Cover Story

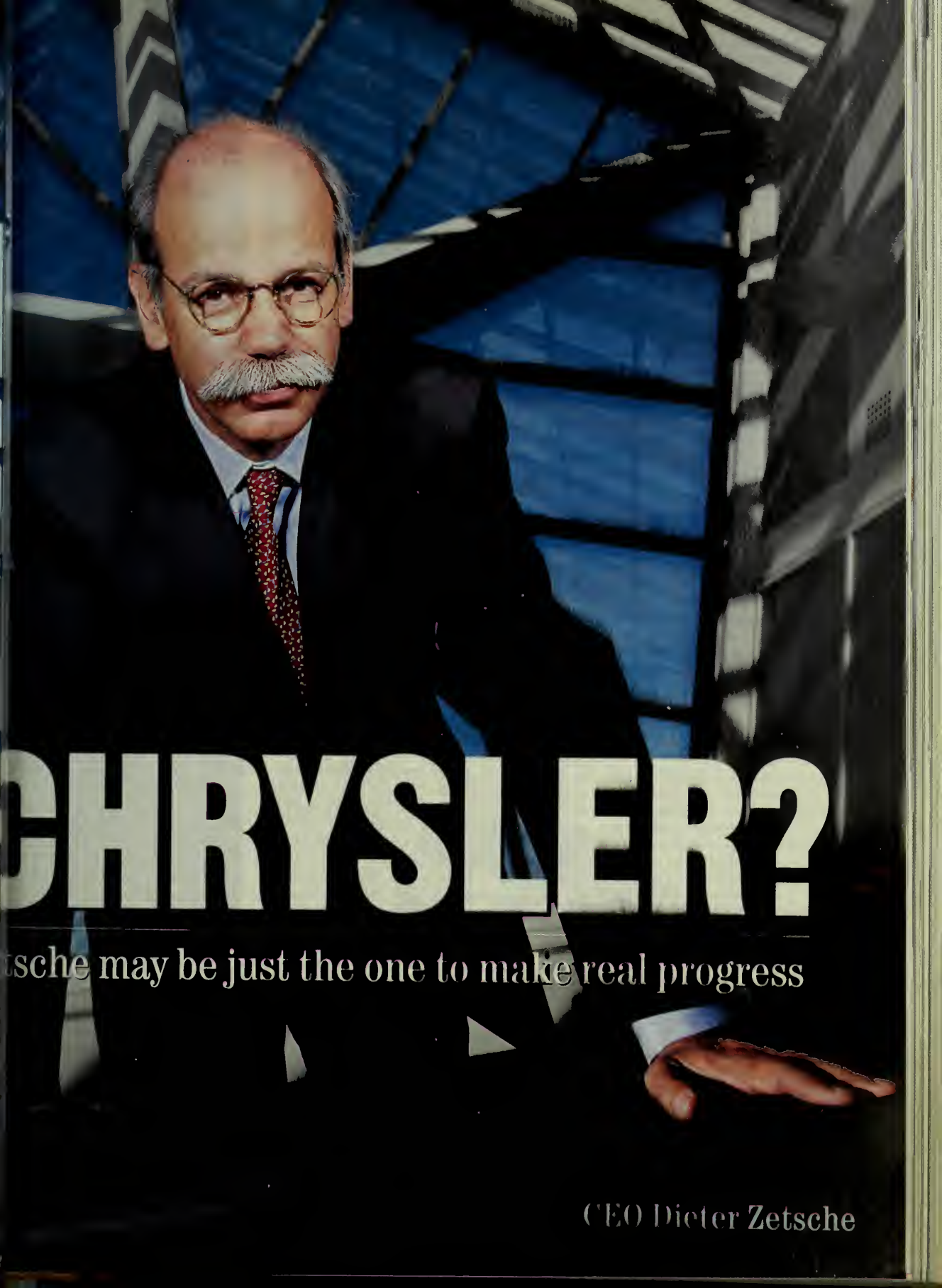
to just 13.5%. And after bringing out the new, \$17,000 Jeep Liberty sport-utility and an updated, \$18,000 Dodge Ram pickup this year, Chrysler won't launch another major vehicle until early 2004. Even then, there's no telling if what's in development will be enough to revive Chrysler.

CASH HOARD. The merger didn't lead to this sorry state, but the turmoil that followed didn't help either. For the first two years, Chrysler's executives floundered as they tried to work with their German colleagues, and almost two-thirds of the senior management was fired or resigned. At the same time, Chrysler's fortunes were shifting rapidly. The company owed much of its success to its ability to avoid competition by creating such innovative, high-margin vehicles as the minivan. But as more efficient rivals such as Honda Motor Co. and Toyota Motor Corp. moved swiftly into the U.S. with similar vehicles and prices began to fall, Chrysler continued to add more expensive features. Before too long, the U.S. auto maker started to suffer. Now, Zetsche, 48, has to turn Chrysler into something it hasn't been for a while: a low-cost producer. "I'm pretty confident we'll get our act together," says Zetsche. "But it's taking longer than I thought when I first came in."

For Daimler, the acquisition has proved costly indeed. In 2000, Chrysler's operating profit tumbled 90%, to just \$500 mil-

CAN THIS MAN SAVE

It's a tall order, but



CHRYSLER?

tsche may be just the one to make real progress

CEO Dieter Zetsche

lion, on \$64.2 billion in sales. As a result, Stuttgart itself reported only \$4.9 billion in profits, a 49% drop, on sales of \$152 billion. It will probably take two more years before DaimlerChrysler even comes close to the profit level it enjoyed during the first full year of the merger. Investors have seen their shares lose more than half their value since peaking in January, 1999, at \$108. The stock now trades at about \$43. Still,

DaimlerChrysler has plenty of cash on hand, some \$11.5 billion. And Schrempp has often dismissed the possibility that he might walk away from Chrysler. The company is integral to his global strategy, he says, and he's not about to abandon

\$108
JAN. 6, 1999

THE MERGER HASN'T PAID OFF YET...

Chrysler's troubles have crimped the stock price of its parent, DaimlerChrysler



that simply because of Chrysler's current problems. "In the financial markets, there is great support for our strategy—and still a question mark about whether we are able to implement it, which I think is a fair assessment," he says.

It is Zetsche who has to prove that Schrempp is right about Chrysler. In February, he started a three-year, \$3.9 billion restructuring. He has announced 26,000 layoffs and has wrested big concessions from dealers and suppliers. Zetsche is also driving out inefficiencies in Chrysler's vehicle-development process to reduce costs and boost quality: DaimlerChrysler ranks only fifth among the seven largest auto makers, according to J.D. Power & Associates Inc. Certainly sharing some Mercedes components should help down the road. In all, he hopes to save \$8.1 billion by 2003. "We're feeling more positive," says Klaus Martini, chief investment officer at Frankfurt's DWS Investment, which owns 1% of DaimlerChrysler's stock.

Cover Story

Along the way, the German engineer has confounded his critics in Detroit, who included almost everybody he works with, by turning out to be a decent, even likable fellow. He has spread a lot of misery, but he has done it with such sensitivity—and often in person—that potential antagonists usually decide to cooperate instead. After so many layoffs, no one expected Zetsche to address a United Auto Workers convention in Las Vegas in March. Indeed, few CEOs have ever ventured to speak at the union's gatherings. Zetsche not only gave a speech but also mingled with the delegates for five hours. "The union and the company are working very well together," says UAW Vice-President Nate Gooden, who handles relations with Chrysler.

While trying to blend in at Chrysler, Zetsche is slowly insinuating himself into Detroit's clubby community. He joined Detroit Renaissance, a nonprofit group of CEOs dedicated to revitalizing the city's economy and has jumped right into the discussions, especially those on school reform. "He's intellectually curious," says the group's president, Paul Hillegonds. These days, Zetsche speaks well of the state he now calls home: His family passed up their usual European summer vacation to explore the wilds of northern Michi-

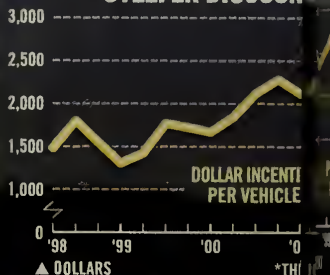
NEEDED: MORE HITS LIKE THE PT CRUISER

gan. And they recently bought a new, lakefront house. Zetsche is no golfer, so he wasn't interested in joining the Bloomfield Hills Country Club, where the auto set gathers. Instead, he can be found at the Bloomfield Hills Hunt Club coaching his 13-year-old daughter in show jumping, or more likely, he laughs, "cleaning up [manure]." Zetsche himself used to be a competitive stunt rider.

GRIM FACTS. But even Zetsche admits his new posting would have been a lot rougher if the auto market hadn't been as strong as it was last year. And "was" is the operative word. Chrysler's sales fell 24% in August from a year earlier, and the grim reality that it won't introduce any new mass-market vehicles until 2004 poses a real danger. "The company's not prepared to deal with the competitive onslaught," says John Casesa, an auto analyst at Merrill, Lynch & Co. For now, Zetsche has to resort to such risky tactics as lowering prices in hopes of moving away from incentives for good.

Of course, Zetsche is also trying to restart development

...CHRYSLER HAS OFFERED STEEPER DISCOUNTS



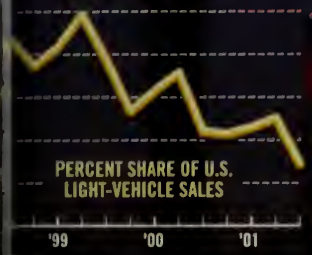
SALES INCENTIVES ARE SKY-HIGH

The German executive has confounded his many Americans

ATES \$5000

r Jeep

...BUT CUSTOMERS AREN'T BITING...



...PROFITS HAVE HIT THE SKIDS....



Source: UBS Warburg, Ward's AutoInfo Bank, DaimlerChrysler, Bloomberg Financial Markets, Deutsche Bank

higher-margin, must-have vehicles, in the vein of the retro PT Cruiser. "We can do it," says Zetsche. "It's in our genes." An even more macho and smooth-riding Dodge Ram pickup that will sell for almost \$1,000 less than current models should help Chrysler compete against the offerings from Ford Motor Co. and General Motors Corp. Zetsche is also keen on expanding the Jeep lineup: He'll probably start with an entry-level vehicle priced below the \$15,000 Wrangler. And by working with Mitsubishi Motors Corp., the struggling Japanese auto maker in which DaimlerChrysler holds a controlling stake, Zetsche hopes to reinvent Chrysler's car business. They will develop small and midsize cars to sell in North America and Asia.

Making Chrysler more efficient is a manageable, if time-consuming, problem for Zetsche. Making DaimlerChrysler the carmaker that Schrempp had in mind, however, is another sort of challenge altogether. The \$36 billion deal was the biggest ever among carmakers, and it pushed rivals around the globe to seek out

But so far, the merger has fallen disastrously short of that goal. Distrust between Auburn Hills and Stuttgart has made cooperation on even the simplest of matters difficult. Coming to terms with such prickly issues as deciding which parts image-conscious Mercedes-Benz would share with scrappy, mass-market Chrysler was all but impossible. Meanwhile, the U.S. company was deteriorating quickly. By the time Schrempp sent Zetsche over, Chrysler had become Daimler's biggest problem.

DIRE STRAITS. Predictably enough, that's what seems to have finally forced the two to attempt to make their union work. Of course, for the Germans it helps that one of their own is now in charge in Detroit. The first Chrysler vehicle to use Mercedes parts extensively will be the Crossfire, a sensuous two-seat roadster that will be available in 2003. Insiders say it will include a Mercedes transmission, engine, and axles. And starting in 2004, Zetsche plans to install Mercedes parts in a widening array of mainstream Chrysler cars, from the next-generation Grand Cherokee SUV to the Dodge Intrepid sedan. But even so, it will be years before DaimlerChrysler can live up to its promise. In the meantime, it may well be that the greatest benefit for the two companies will be that they share technology. It will be a success, but a smaller one.

If Zetsche manages to rebuild Chrysler and integrate it into Daimler, he will vindicate his boss, the 56-year-old Schrempp. And Zetsche will no doubt greatly improve his chances of one day running the auto giant. But if Zetsche fails, the deal will be condemned as one of the biggest flops in corporate history—and both men could find themselves on the wrong side of the DaimlerChrysler supervisory board. "This is a test of a young executive with a lot of brains and charisma," says Ronald Harbour, president of automotive research firm Harbour & Associates. "It really doesn't matter how good he is. He couldn't have a tougher time to try to make this transformation."

Chrysler has been in dire straits before. It took a federal bailout to save the company in 1979 and a complete product overhaul to recover from near-bankruptcy a decade later. Today, however, globalization has transformed the industry. Japanese and European auto makers have edged out the Big Three in the car market and are pushing into trucks and SUVs as well. That's a particular threat to Chrysler, which last year looked to its minivans, Jeeps, and pickups for 80%

...AND FEW NEW MODELS TILL 2004



SUV ENTRY: THE JEEP LIBERTY

of sales. While Zetsche is careful not to criticize Holden or any other former executives, he's cer-

partners of their own. Schrempp's idea was to create a company that would couple Mercedes' engineering with Chrysler's marketing and design savvy to develop a vehicle for every kind of driver; a glossus that would sell cars everywhere from Buenos Aires to Beijing. It would be extremely competitive: Chrysler and Mercedes would share parts and the cost of developing expensive new technologies. It would be an unprecedented combination of prestige and market power. It would be the global standard.

tain that the strategy Chrysler used to great advantage in the 1990s wouldn't work in today's more brutal environment. "Competition is everywhere," he says.

That's why Daimler Benz and Chrysler began their grand experiment in globalization. But the Germans and the Americans have been out of sync from the start: The two proud management teams resisted working together,

\$43
SEPT. 4, 2001

tics by turning out to be a decent, even likable fellow



BORN May 5, 1953, in Istanbul to German parents working abroad. Two years later, the family returned to Germany.

EDUCATION Master's degree in electrical engineering, University of Karlsruhe, 1976; PhD in mechanical engineering, Paderborn Technical University, 1982.

CURRENT POSITION President and CEO of Chrysler Group; member of the management board at DaimlerChrysler.

FIRST JOB Driving a beverage truck in Frankfurt.

FIRST CAR 1971 Volkswagen Beetle.

TEENAGE PASSION Competed in the sport of equestrian vaulting, which involves performing acrobatic stunts on a galloping horse.

CAREER BREAKS Impressed his bosses at Daimler Benz a decade ago by rescuing Mercedes in Argentina and Freightliner in the U.S. He returned to Germany to help overhaul the Mercedes brand.

GETTING ACCLIMATED Instead of their usual European vacation this summer, Zetschke and his family rented a cottage in northern Michigan. And he joined the Bloomfield Hills Hunt Club, where his daughter stables her horse.

FAMILY Married for 18 years, to Gisela. Three teenage children—and one cocker spaniel, Carlito.

were wary of change, and weren't willing to compromise. Daimler and Chrysler have combined nothing beyond some administrative departments, such as finance and public relations. Talk of synergy might as well have been *verboten*. Mercedes executives worried their buyers might feel cheated if they shared parts with the American auto maker; Chrysler resented the implication that its technology was inferior.

The strange truth today is that only a German can save the American icon. Even Holden admits Zetschke has a better chance of succeeding at Chrysler

Cover Story

than any U.S. executive would. Zetschke wants to be called a "Chrysler guy," but the fact that he worked at Daimler for 25 years makes all the difference. First, he has Schrempp's confidence: Holden was fired after predicting that Chrysler wouldn't turn a profit until 2003. When Zetschke made the same forecast, Schrempp accepted it. And Zetschke's relationships with managers in Stuttgart—especially Mercedes boss Jürgen Hubbert—have made it easier for him to pry loose technologies and components that no American could get his hands on. Of course, the crisis helped. For example, DaimlerChrysler may save \$100 million in engineering costs by cloning a Mercedes transmission for Chrysler sedans coming out in 2004. "Being in trouble makes it easier to understand that you have to change," says Zetschke. "In Germany, they understand we are in one boat." But it took a German to make them understand.

Few were surprised that Schrempp chose Zetschke to take on DaimlerChrysler's greatest challenge. He's fast, decisive, and an experienced troubleshooter. Zetschke revived Daimler's Freightliner truck business, in Portland, Ore., by cutting a quarter of the workforce and reducing capacity. (The company and the U.S. industry, however, are now in a slump.) As chief engineer at Mercedes in the early 1990s, he fought off

Japanese rivals by expanding his lineup and making development more efficient. At 38, he was the youngest member ever of Daimler's management board. Later, he took over Mercedes' sales and marketing and came away with a keen understanding of the consumer side of the business.

DECISIVE. As it turned out, Zetschke had just the combination of humility and warmth to ease tensions among Chrysler's demoralized staff. He eats in the cafeteria, interrupts plant tours to talk with workers, and even promised to shave his head (he's already half-bald) if the new Dodge Ram again topped the J.D. Power & Associates quality survey. His town hall meetings are so popular that plant officials resort to a lottery to choose participants.

Zetschke's decisive leadership is welcome relief for an outfit that drifted aimlessly after the merger. "There's not a single employee around here who didn't know this company was in trouble," says James D. Donlon III, senior vice-president and controller. "They just needed somebody to get up and tell them like it is." That's true for those outside Chrysler as well. Three weeks into the job, Zetschke demanded that suppliers swallow an immediate 5% price cut. That alone should save Chrysler \$2 billion this year. And to keep Chrysler's business, suppliers must wring out a further 10% by 2003, which

DAIMLER-CHRYSLER CEO SCHREMPF

Now, he says, "it's as if somebody took their foot off the brake"

should cut Chrysler's costs by an additional \$4 billion. Zetschke has explained to many suppliers just how dire things are. While about one-tenth of the suppliers have walked away among those remaining "the violent anger is gone," says Ned DeKoker, managing director of the Original Equipment Suppliers, which represents auto-parts makers. "It has been replaced with sincere frustration. You wish you could help."

So far, Zetschke is ahead of schedule





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in his cost-cutting, partly because more people than expected retired early and plant managers found unexpected ways to save. Shutting down the escalators at one factory, for instance, saved \$80,000 a year. Manufacturing boss Gary L. Henson says he can probably cut \$1 billion annually, three times his target. A second-quarter operating loss of just \$125 million was a better result than Wall Street had predicted.

But as sales continue to slow, Zetsche needs to keep buyers coming in the door without offering big incentives. "We need to find the sweet spot between volume and profits," he says. To get away from the rebate game, he is lowering base prices: The 2002 Jeep Grand Cherokee will now start at \$25,400—\$2,000 less than the sticker price of the 2001 model—and the 300M sedan will sell for \$28,300—\$1,200 less than last year's model. It's a potentially dangerous move, however, since other auto makers could respond with their own aggressive cuts.

In terms of product development, Zetsche wants Chrysler to balance style with thrift—an approach he calls "disciplined pizzazz." He is overhauling the vehicle-development process to put more focus on the earliest stages. By pulling together teams from all areas of the company—design, engineering, marketing, manufacturing, and purchasing—Zetsche hopes to reduce waste and resolve nagging quality problems without diminishing Chrysler's creative instincts. It's an approach that Chrysler itself pioneered in 1989 but couldn't stick with. Zetsche is also borrowing Mercedes' system of "quality gates." This allows Zetsche and his team to review a vehicle at each of 11 checkpoints throughout the three-year development cycle. If they don't think the vehicle is ready to pass through, they send it back for work. "If he can combine Chrysler's passion for design with German engineering and drivability, he may pull it off," says Christopher W. Cedergren, an analyst at Nextrend Inc., a Thousand Oaks (Calif.) research firm.



GERMAN IMPORT

When No. 2 Bernhard came to aid Zetsche, "it was just the two of us"

Still, skeptics contend that selling \$50,000 sedans is not prepared Zetsche to deal with the cutthroat business of moving Dodge. "He's got experience in America, but it's not Mercedes. It's not

trying to put Neons over the curb," says Steve Rossi, who was a public relations executive for both Chrysler and Mercedes in the U.S. and now CEO of McLaren Performance Technologies.

Certainly nobody rolled out the welcome wagon when Zetsche arrived in Detroit in November. For resentful company veterans, Zetsche's appointment confirmed their worst fear: that Chrysler had lost what remained of its independence. Naturally, tensions were high at an early press conference when a reporter asked the question on nearly everyone's mind: "How many more Germans are you going to bring over?" Zetsche leaned into the microphone and answered: "Four." A wide smile appeared through his enormous moustache. "My wife and three kids."

DIPLOMACY. That disarming response, brilliantly timed, helps explain why the workout guy from Germany is one of the most popular executives in Detroit these days. He's diplomatic in an industry more used to hostile encounters. In January, he told Chrysler dealers the company planned to take away subsidies worth \$300 to \$500 per vehicle. This could save Chrysler as much as \$1 billion. When dealers balked, Zetsche agreed to consider alternatives that would deliver the same result. In the end, he accepted a proposal that would allow dealers to make up the lost money with bonuses for beating new sales targets.

In putting together the cost-cutting initiatives, Zetsche has counted on Wolfgang Bernhard, 40, his bright, German chief operating officer. (O.K., so he brought five Germans over.) Bold and at times brash, the high-energy Bernhard is a sharp contrast to the thoughtful, analytical Zetsche. But the two have a close working relationship, partly because they

Cover Story

ALL IN THE FAMILY

Chrysler shares almost no components with its sister companies, Mercedes and Mitsubishi. But Zetsche's plan hinges on changing that in four crucial segments:



SMALL AND SPECIALTY CARS

Dodge Neon (above)
Crossfire

The 2003 Crossfire gets several Mercedes parts. Mitsubishi will engineer the 2005 Neon's underpinnings; Chrysler will design the interior and body.



MIDSIZE CARS

Chrysler Sebring (above)
Dodge Stratus

Chrysler will handle most of the engineering for 2006 models and share the platform with Mitsubishi. Chrysler expects each joint project to save \$100 million.



BIG CARS

Dodge Intrepid (above)
Chrysler Concorde

Chrysler will design 2004 replacements for these cars using Mercedes E-Class rear-wheel drive transmission, electronics, and steering column.



SUVs, TRUCKS, OTHER

Jeep Grand Cherokee (above)
PT Cruiser

This year, Chrysler will offer Mercedes diesel engines in Europe, and its 2005 Grand Cherokee will share components with the Mercedes M-Class SUV.

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Global network of innovation

POTHoles UP AHEAD

Zetsche wants to rev up Chrysler by cutting costs and boosting revenues, but he faces plenty of obstacles

SUPPLIER REVOLT

Zetsche demanded that parts suppliers reduced prices by 5% immediately—and by a further 10% over the next two years. But these outfits are already struggling, and they say Chrysler is squeezing too hard.

DEALER UNREST

Chrysler angered dealers when it cut financing and marketing support by \$300 to \$500 per vehicle. The two sides negotiated a more acceptable solution.

**APPROACHABLE:
WORKERS CAN TELL
ZETSCHKE HOW IT IS**

PRODUCTIVITY LIMITS

A lack of factory flexibility, along with labor pacts that ban plant closings, are hampering efficiency efforts.

REBATE TREADMILL

Kicking the incentive habit is proving harder than expected in the hypercompetitive U.S. market.

DRY PIPELINE

Chrysler rolled out the Jeep Liberty and new Dodge Ram this year. It won't launch other major products until early 2004.

outsiders. "When we came over, it was just the two of us," explains Bernhard. "You feel like you're in a life raft in the ocean. You can only work together if you have complete confidence in each other."

Zetsche is also devoting a good deal of time to making sense of the merger. DaimlerChrysler is expected to announce soon that by yearend Chrysler will offer Mercedes diesel engines in the Grand Cherokees and the PT Cruisers it sells in Europe. The Crossfire will be only a niche model, but it wowed enthusiasts at this year's auto shows, and Chrysler hopes it will generate excitement about the company's full-size sedan and its next-generation Jeep Grand Cherokee, which will borrow parts from the updated Mercedes M-Class SUV.

Zetsche admits that a "not-invented-here" syndrome kept Chrysler and Mercedes from sharing much in the beginning. It took a group of senior executives several months to put together what Schrempf calls the company's brand bible, which decrees what is sacred about both Mercedes and Chrysler. In fact, it was Zetsche and Holden who led the effort; Zetsche jokingly called himself the brand pope. And while each request is still carefully debated in Stuttgart by a newly established executive automotive committee, "certainly the momentum is stronger now," he says. Schrempf agrees: "It's as if somebody took their foot off the brake."

NO RANCOR. Zetsche is paying close attention to vehicles already in the works when he arrived, especially a sport wagon due in 2003 (it will look like an SUV but drive like a car). Chrysler had planned to sell the vehicle as a luxury car, in the range of \$35,000 to \$38,000. But Zetsche persuaded the planners to make it more affordable by stripping out a few features: Now, it will start around \$28,000. "He has a great way of removing some of the emotion," says Richard O. Schaum, executive vice-president for product development and quality. Zetsche also felt "there wasn't enough tension" in the design of the sport wagon's grille. And he told the engineers to reinforce the



car's structure to ensure it would earn a five-star crash rating from the government, even though it meant a six-month delay at a crucial time.

But executives have to know when to trust their managers, too. Consider the case of Aerosmith—that's right, the heavy-metal rock band. A few months ago, James C. Schroer, the Ford executive Zetsche recruited to head Chrysler's sales and marketing, presented him with the idea of using Aerosmith to promote the new Ram. Zetsche asked a few sharp questions and then agreed, although he was only vaguely familiar with the band. He made a point to find out, though. Two weeks later, he, Schroer, and other Chrysler executives attended the Aerosmith concert kicking off the campaign. Zetsche liked the match of the band's in-your-face music and the brawny Ram, but there was nothing on stage that said Dodge. Zetsche leaned over to Schroer, smiled, and shouted: "I see more Dodge Ram or I cancel the program." It was the kind of brush-back Zetsche is known for: humorous, not rancorous.

Still, it must be galling to Zetsche that he's in such a precarious position.

HEAVY METAL

Zetsche agreed to link up with Steve Tyler's Aerosmith to promote the Ram pickup

But no one has ever become a Chrysler guy without going through a near-death experience. And if he can actually help turn DaimlerChrysler into a successful global auto company, then Zetsche

can pretty much call himself whatever he wants. Otherwise, his name will likely join the list of other casualties of a \$36 billion mistake.

By Joann Muller in Auburn Hills, Mich., with Christine Tierney in Frankfurt



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INVESTING

HEDGE-FUND FOLLIES

Many former mutual-fund stars who jumped to the long-short league have now limped off the field

The tech sector is going straight up." These fateful words marked both the beginning and the end of Craig Ellis' brief stint as a hedge-fund manager. The day was June 26, 2000, and Ellis was rattling off stock picks for CNNfn's *Talking Stocks* broadcast. It was also day one of his Madison Avenue hedge-fund firm, Safari Capital Management. Ellis was banking his future on past accomplishments, namely a 168% return in 1999 for the Orbitex Info-Tech & Communications Fund. He had a short list of must-have stocks, all but one of which were losers by December—as was Ellis' new venture. Today, Ellis is living in his fixer-upper home in South Hampton, N. Y., on Long Island, and he's unemployed. "I tried, and I didn't do well," he says. Now, "I'm a plumber and a carpenter."

Ellis is one of a slew of hot-shot mutual-fund managers who have sought their fortunes in the \$500 billion hedge-fund business. Lured by the prospect of earning a typical annual management fee of about 1% of assets and a heady 20% of profits—translating to salaries in the millions, rather than hundreds of thousands—many abandoned the security of large fund shops to strike out on their own. But the odds in favor of a new

hedge fund hitting it big are slim. "Half of them that survive the first six months are dead two years later," says Stephen J. Brown, a professor at New York University's Stern School of Business. With mutual-fund managers turned hedge-fund managers, the chances of success are even slimmer. "These former mutual-fund managers tend to fall in love with their positions and stay too long on the down side," says Charles J. Gradante, managing principal of Hennessee Hedge Fund Advisory Group. "More than half end up failing."

Hedge funds, which tend to carry six-figure minimums, cater to wealthy and institutional investors and try to make money in both bull and bear markets. It doesn't matter which way the stock market is headed because hedge-fund managers have the flexibility to employ strategies, such as buying put options and selling short, that pay off when a stock's price falls. They also use leverage, or borrow money, to boost returns, or make concentrated bets on a single stock—all risky tricks of the trade that standard-issue mutual-fund managers are neither trained nor allowed to do. "The mental set that allows you to be short, and the conviction to get your portfolio closer to market-neutral or even net-short, is very, very difficult," says Robert I. Schulman, president of Tremont Advisors Inc., a hedge-fund consulting firm. The CSFB

Craig Ellis' Safari Capital Management had its beginning, and its end, in 2000



Villanova Capital's Aaron Harris is suddenly spending most of his time managing risk

Tremont Hedge Fund Index is up 2.7% as of July 31 (the most current data available), vs. an 8.1% loss in the average equity mutual fund and an 8.3% decline in the Standard & Poor's 500-stock index.

There are no hard numbers on how many mutual-fund managers shifted to running hedge funds—or how many of those funds have folded. The industry is unregulated, and players shroud themselves and some 8,000-plus funds in secrecy. Advertising is against the law, and returns are not public information. One thing, though, is for certain: New money from investors seeking refuge from the falling stock market has been rushing in—some \$8.4 billion in the second quarter alone. That's more than in all of 2000, according to TASS Research Inc., a unit of Tremont. The rush has attracted many newcomer funds, which now outnumber top-notch talent.

Even industry veterans have failed to brave the market storms. Since leaving Long-Term Capital Management but in 1998, Julian Robertson of Tiger Management—once the world's largest hedge group at \$22 billion—shut down in March 2000 after investors fled.



orly performing funds. George Soros as forced to liquidate most of his Quantum Fund to meet redemptions, and Jeffrey N. Vinik, a former Fidelity Agellan manager, also quit, returning \$2 billion to clients. And former mutual-fund managers who have decent track records with hedge funds have hit the skids, too. Ken Londoner spent dozen years in retail funds with J. & Seligman & Co. and State Street Research Investment Services Inc. before starting Red Coat Asset Management, a New York-based hedge fund. The \$375 million fund earned a compounded annual return rate of 29% for three years, until 2000: The startup was a near-casualty by concentrating too few media and telecom positions. Losses wiped out 75% of the fund's assets.

Many of the newest hedge-fund managers got into the game at the height of their mutual-fund careers—and the bull market. Emmy Sobieski and Aaron Harris—former co-managers of the Nicholas Applegate Global Technology Fund, up 494% in 1999—both left to run separate hedge funds last year. Sobieski joined Palantir Capital Management in

New York, while Harris hooked up with NationsBank's asset management arm, Villanova Capital. Harris, who concedes he'll "never look as smart as I did" in 1999 has managed the new \$10 million Villanova Global Tech Long-Short Fund for three months. Spending about 30% of his time picking stocks and the rest managing his risk, he says: "I'm learning."

OUT OF THE NEST. But not all newcomers have the backing of a financial powerhouse, and so they're disappearing from sight. "Their phone is disconnected or they've got some horrible story to tell you," says Jeffrey F. Kuchta, chairman of Chicago's Hedge Advisors Inc., which invests only in hedge funds with five-year track records and \$100 million under management. In 1998, James "Chip" Otness left J.P. Morgan Chase & Co. to launch his own hedge-fund firm, Dolphin Asset Management. The startup failed, and he's back managing mutual funds for someone else—Goldman, Sachs & Co. Another superstar, Erin Sullivan, whose \$17 billion Fidelity Aggressive Growth Fund earned a 103% return in 1999, may have fallen off the map, too. Sullivan, who launched Spheric Capital Management in Boston, would not return phone calls for this article. "Erin won't speak to anyone," says Michael Ocran, editor-in-chief of *MAR Hedge Fund Report*, who adds that she declined to speak at an industry conference last year. "She's having a real tough year," says James H. Lowell, editor of Fidelity Investors' newsletter, who has contact with her investors. "I would assume by now a lot of these managers are having to go begging for money."

The mutual-fund managers who are likely to attract big money are those who align with pedigree hedge-fund names. David Felman, former partner of the \$7 billion Fidelity Mid-Cap Stock Fund, recently joined Daniel C. Benton, former partner of the renowned Pequot Capital Management.



Former Fidelity star Erin Sullivan is "having a real tough year," says an industry watcher

ONLY THE STRONG SURVIVE

YEAR	NUMBER OF HEDGE FUNDS THAT FAILED	FAILURE RATE
1995	79	7.7%
1996	145	12.2
1997	119	9.2
1998	174	12.2
1999	253	17.5
2000*	288	12.0

Data: Based on funds tracked by TASS Research
*BW estimate

Benton's new Andor Capital Management will launch a fund on Oct. 1 with about \$10 billion, sources say. Grady Durham, president of Denver's Monticello Associates, which advises on \$30 billion, doesn't invest in startups. But he's watching this one closely: "The best of breed usually comes out of the blue-chip [hedge-fund] shops," he says. "They don't come out of any mutual-fund company."

Others agree. Capital Z Partners LLC not only invests in hedge funds, but also takes a stake in the fund's management company, if it spots potential. Partner Sharissa Y. Jones has interviewed 500 startup hedge-fund managers in the last year, some of whom came from mutual funds, but only five made her cut to receive up to \$55 million in seed money.

With the markets treading water and a rush of cash continuing into hedge funds, buy-and-hold mutual-fund managers' hands are tied. Their exodus, therefore, is likely to continue, even though they face the high risk of failure.

By Mara Der Hovanesian in New York

VENTURE FUNDS

MATRIX BETS ON WIRELESS

In a weak economy, Managing Partner Paul Ferri's winning streak is on the line



Since the great tech wreck of 2000, life for most venture capitalists has been rough. They're making fewer investments, marking down the value of those they have, and facing headaches raising new cash. Not Paul J. Ferri, however. In the past 12 months, the managing partner of Matrix Partners of Waltham, Mass., has invested \$101 million in 13 companies, mostly wireless communications startups. And in May, he raised \$1 billion for his latest fund—more than double what he raised in the 1990s.

Matrix is a magnet for new money because it was one of the nation's most profitable VC firms through the 1990s, says Steven Lisson, who tracks venture funds at his Web site, InsiderVC.com. The best performer among Ferri's three funds returned 20 times its investors' money from its formation through Dec. 31, 2000, and his worst seven times the original investment (table). Matrix sold many of its big winners near the top of the market. For example, it paid 20¢ a share for optical networking company Sycamore Networks

Inc. in 1998 and sold last year at \$107 a share, for a 53,400% gain. Just six companies out of 60 that Matrix backed—including the only two dot-coms—were losers. "What's unique about Matrix is that most top firms do have an occasional weak fund," Lisson says, "but Matrix does not."

GROUND RULES. The Italian-born Ferri sidestepped the tech meltdown by following strong, even rigid, investing rules that he has developed over a 30-year career as a venture capitalist. For starters, he steers clear of fanciful theories—such as the idea that Webvan Group Inc., which filed for bankruptcy in July, would create a whole new business model for grocery distribution. Instead, Ferri focuses on technology

BIG RETURNS AT MATRIX

FUND	YEAR	SIZE MILLIONS	RETURN*
PARTNERS III	1990	\$80	773%
PARTNERS IV	1995	125	1,997
PARTNERS V	1998	200	1,563
PARTNERS VI	2000	319	N/A

*Actual proceeds to investors from liquidated investments (stock distributions or cash from sales), as a percentage of committed capital, as of Dec. 31, 2000

Data: InsiderVC.com

strategy. Another rule: One of its partners, many of them experienced engineers and executives, must be on the board.

Now, despite the extensive overcapacity that's wreaking havoc on telecom startups and giants alike, Ferri is betting big on wireless technology. He doesn't consider the strategy to be all that risky, as wireless business is still growing fast—at a nearly 30% clip, according to Merrill Lynch & Co. "All startups are selling into markets where there is still demand for new products," Ferri says.

All the same, Matrix's new investments are focused on one of the most volatile sectors of the tech industry. But Ferri says he's much happier now than where he was in the 1980s. Back then, he diversified into tech, retail, and health care. The results were not spectacular, and the experience left him focused almost exclusively on tech equipment and software companies.

PATIENT: Ferri concedes he doesn't expect big returns in the near term

Winphoria Networks Inc. is typical of the companies currently being funded by Matrix. The Tewksbury (Mass.) startup was co-founded by Shamim Naqvi, a former top Lucent Technologies Inc. engineer. Next year, Naqvi says, Winphoria plans to release new wireless switching equipment at half the price but for five times the capacity of today's switches—making it potentially a high-priority purchase by battered wireless carriers. "We're not a sexy company, but it won't be hard for our customers to justify the cost of buying our product," says Naqvi.

Ferri admits that near-term weak economy could prevent many customers from buying the products Winphoria and others are developing. So he is prepared to wait three or four years—instead of one or two—to earn a return on his investments. And he is planning to invest more money in his companies—double or triple the \$8 million to \$10 million investments that he typically made over the past 10 years. "I know we'll never have the returns I had in the past," says Ferri.

No doubt Ferri's winning streak will be sorely tested in the next few years. Not only is the tech industry struggling, he has also got far more to invest than ever before. But Ferri's disciplined approach may see him through.

By Geoffrey Smith in Boston

COMMENTARY

By Otis Port

FAREWELL TO A VISIONARY OF THE COMPUTER AGE

Michael L. Dertouzos has returned to his beloved Greece for the last time. The longtime director of Massachusetts Institute of Technology's Laboratory for Computer Science (LCS) was buried on Sept. 4 in First Athens Cemetery, not far from his boyhood home and near the finish line for the Olympic Marathon. He died on Aug. 27, at 64, of heart failure.

Dertouzos took great pride in being Greek and relished the role of high-tech oracle for most of his four decades at MIT, where he earned an electrical engineering PhD in 1964. After being named LCS head in 1974, he prophesied that up to 33% of American homes would have a personal computer by the mid-1990s—never mind that PCs back then were crude build-it-yourself kits. And in 1980, when the forerunner of today's Internet was the exclusive domain of researchers at a few dozen universities, he foresaw it evolving into an "information marketplace" for conducting business globally.

But an uncritical cheerleader for high tech he was not. Indeed, he grew increasingly dismayed with PC technology during the 1990s, especially Microsoft Corp.'s Windows operating system, which he thought was getting more and more turgid. Sometimes, he'd lose his cool and make vitriolic statements about Windows, but then quickly add, "Please don't quote me." He didn't want to alienate Microsoft to the point where it wouldn't listen to his ideas for more intuitive, people-oriented systems.

PEEVES. Many of his pet peeves were laid out in 1999 in *The Unfinished Revolution: Human-Centered Computers & What They Can Do for Us*, the last of his eight books. In it, he envisions PCs that respond to spoken commands in everyday language—devices that wouldn't balk if you said something like: "Find me the cars

with the most back-seat legroom combined with the best mileage and the lowest cost, and show me the top five." He doubted that Microsoft would forsake Windows' profits to develop a radically new system. But to avoid losing the company's support on other issues, he'd blunt his Microsoft barbs with irony, wondering, for example, why you shut down a PC by clicking on "Start."

Microsoft may have starred in his hall of shame, but Dertouzos regularly took the whole computer industry to task. Even the operating system in his favorite machine, the Macin-

fectious. His passionate pleas for reform were aimed mainly at things he knew could be fixed. Technologies to simplify computing were in hand, or coming soon, he'd insist. The big worry was that companies might lack the mind-set to exploit them.

Dertouzos didn't just talk about what should be done. In the 1980s, he played a key role in Project Athena, the first campuswide computer network in academia. For it, LCS created a windowing capability for the Unix operating system, which later helped physicist Tim Berners-Lee invent the World Wide Web. Off

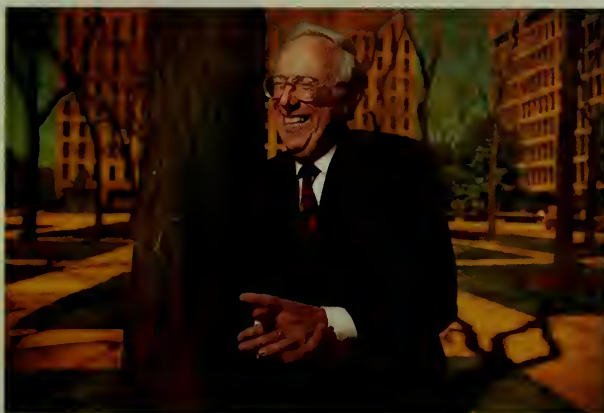
campus, Dertouzos co-founded some of the 50-odd companies that sprouted from research at his lab, including Lotus, PictureTel, RSA Security, and Tibco Software. The latest one, Curl Corp., has software for building multimedia Web sites with no-wait response times.

The capstone of his career, though, is the Oxygen Project, the most ambitious undertaking in LCS history. Started in 1999 with funding from the Pentagon's Defense Advanced Research Projects Agency and backed by the likes of Hewlett-Packard, Nokia, and Philips, as well as MIT's own Artificial Intelligence Lab, this \$50 million effort aspires to make computers

as easy to use as air is to breathe—and equally pervasive. Dertouzos sketched this whole landscape in *The Unfinished Revolution*, and he had hoped to begin plucking the project's initial fruits by around 2003.

If the Oxygen Project delivers on its promise, it will help the world evolve from "computer autocracy to computer democracy," as Dertouzos wrote in his last book. That would be a fitting legacy for a transplanted Greek.

Dertouzos was a frequent sounding board for Senior Writer Port, starting in 1982.



From his perch at MIT, Michael Dertouzos aspired to make PCs as easy to use as air is to breathe

tosh from Apple Computer Inc., got pretty low marks. He lambasted software companies for piling on marginal features in incessant upgrades that can downgrade user efficiency. When he and I last spoke, in October, 2000, he continued to decry the senseless complexity of PCs. Even computer gurus like himself, he groused, were often reduced to "random trial-and-error tinkering to get programs to work together properly, which I find maddening."

If all this carping makes Dertouzos seem like a pessimist, he wasn't. He was an upbeat character who grinned a lot, and his smile was

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Hertz
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Developments to Watch

EDITED BY CATHERINE ARNST

ENOUGH JUICE TO RUN YOUR LAPTOP FOR DAYS

TODAY'S ULTRALIGHT LAPTOP computers run at blazing speeds. But they're energy sponges that often deliver a meager two hours of continuous use. That should change in the next couple of years, when Japan's NEC Corp. hopes to offer a powerful, compact fuel cell as an energy source. These devices convert the chemical energy of fuels such as hydrogen into electricity by means of an electrochemical reaction. But NEC has added a twist: It plans to fashion a key part of the fuel cell from carbon nanotubes.

Nanotubes are long, cylindrical molecules made up of a lattice of carbon atoms. First created 10 years ago by Sumio Iijima, an NEC scientist, they're 100,000 times thinner than a human hair but stronger than steel. And they conduct electricity better than copper.

In their latest breakthrough, Iijima and his team have covered horn-shaped nanotubes that can serve as highly efficient electrodes in fuel cells. Thanks to their shape, the "nanohorns" cluster together to provide an immense surface area for electrochemical reactions, boosting the efficiency of the fuel cell. Although still in an early stage of development, the new device promises to provide 10 times the power capacity of a high-density lithium-ion battery of comparable size. That means enough juice to run a laptop nonstop for several weekdays. "We have two to three years work ahead of us," says Iijima. "But I think we'll be making a contribution." *Irene M. Kunii*

WINDOWS THAT WASH THEMSELVES

THE PICTURE-PERFECT homemaker of the 1950s may have spent hours polishing her panes, but these days, who has time? Now, the latest in window-glass technology offers hope for the house-proud trapped behind filthy windows. Recently, Britain's Pilkington PLC and rival PPG Industries Inc. of Pittsburgh have introduced window glass that practically cleans itself.

Both Pilkington's offering, dubbed Activ, and PPG's SunClean consist of glass that is treated with a thin layer of chemical compounds. The treatment keeps grime at bay in two ways. First, in the presence of sunlight, the chemically active surface breaks dirt down and prevents it from building back up. Second, the transparent chemical layer loves water, so the surface holds and sheds water in sheets rather than drops.

Fewer drops means fewer spots, says PPG's Victor L. Skukalek, project manager for SunClean. And when the high-tech glass does require cleaning, dirt comes off more easily. "You can just hose it down," he says. That may justify the anticipated 20% premium for windows containing SunClean panes.

Adam Aston



ZAPPING THE ZEBRA MUSSEL WITH RADIO WAVES

ENVIRONMENTAL AUTHORITIES estimate that tens of millions of dollars have been spent every year since the mid-1980s to combat the zebra mussel. The marble-size mollusk was inadvertently introduced to the Great Lakes from the ballast water of oceangoing freighters. And in recent years, they've spread through shipping canals into the Mississippi. But now, scientists may have a weapon to stop the invasion.

Researchers at Purdue University's Calumet campus have discovered that zebra mussels can be killed by zapping them with extremely low-frequency electromagnetic waves. Moreover, the researchers found that the

radio waves do not seem to harm fish or native shellfish. That represents a big step up from existing approaches, in which chemicals such as chlorine and bromine are used to poison the fast-reproducing mussels and keep water-intake pipes clear.

The researchers conducted their experiments by beaming radio waves at aquariums stocked with different species of aquatic life. After 40 days, the zebra mussels had all died. Matthew F. Ryan, a chemistry professor leading a team of undergraduates in the work, speculates that the low-frequency waves work by causing an ion imbalance in the mussels. Field tests are planned this fall in Lake Michigan to see how well Purdue's ray gun works outside its labs.

Michael Arndt

ZEBRA MUSSEL:
Multiplying



THESE THERAPIES SEEK OUT AND DESTROY CANCER

CANCER TREATMENT IS BEING revolutionized by targeted therapies that home in on diseased cells without harming healthy tissues. Some such drugs have already been approved by the Food & Drug Administration—notably Novartis' Gleevec, a highly effective treatment for a rare form of leukemia.

On Sept. 11, an FDA panel will review the application for one of the first of a subclass of these tumor-specific drugs: antibodies that are combined with radioactive isotopes. These radioimmunotherapies use the antibody to seek out receptors found only on specific cancer cells, and then deliver their deadly cargo to the tumor. Because injecting radiation into the blood seems inherently risky to many doctors, the FDA is moving cautiously. It delayed the approval process for both leading candidates, demanding more data.

The September meeting will consider Zevalin, made by IDEC Pharmaceuticals Corp. The drug is an enhanced version of IDEC's Rituxan, an antibody used to treat non-Hodgkin's lymphoma. Zevalin combines an antibody similar to the one in Rituxan with yttrium-90. In Phase III clinical trials, Zevalin produced an 80% overall response rate in the sickest non-Hodgkin's patients. Analysts say the FDA panel will most likely recommend approval of Zevalin. If so, the drug would reach the market early next year.

Bexaar, a drug made by Corixa Corp., in partnership with GlaxoSmithKline, also treats non-Hodgkin's lymphoma. The company completed filing the additional data requested by the FDA in early August, but a review hasn't yet been scheduled. ■

TELECOMMUNICATIONS

THOSE WIRES SURE ARE COLD

And prospects of a telecom recovery are proving elusive

The promise of recovery in the telecom industry is like a mirage: As the thirsty traveler trudges through the desert, his vision of a cooling oasis just ahead dissolves and reappears farther off. After witnessing the 25% capital-spending hikes of telecom's boom years swing to a decline in 2001, analysts were sure they could see recovery on the horizon by the middle of 2002. Then it was late 2002.

Now the tantalizing vision of growth has been pushed back until at least 2003. New evidence shows that capital investments by telecom companies may decline an astonishing 20% next year. That's twice as much as most experts had been expecting and far worse than the 5% falloff in 2001—the industry's worst year on record.

"IT'S SCARY." The first signs of worsening came on Aug. 29, when WorldCom announced that its capital spending would total \$5.5 billion in 2002, 31% less than this year and 20% less than it had originally planned for next year. The same day, Corning Inc., which supplies optical fiber for telecom networks, warned that it would miss its financial targets because of a "sudden slowing in orders." And in a study released on Sept. 4, Lehman Brothers Inc. found many of the country's largest telecom companies will cut their capital budgets for next year by 20%, to \$82 billion

from \$102 billion in 2001 and \$107 billion in 2000. "Very few people really have any idea of what terrible shape the telecom industry got in. It's scary," says Lehman analyst Blake Bath, who was among the first to spot telecom's unsustainable spending.

Blame the latest declines on big carriers, which account for 75% of industry expenditures.

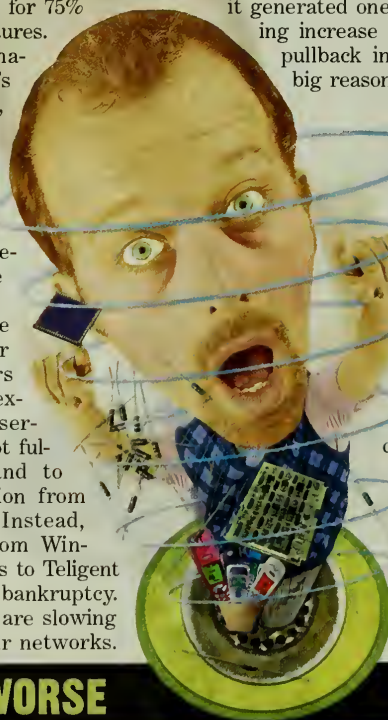
They're taking machetes to next year's capital budgets, largely because many parts of the phone network have more than enough capacity to meet current demand, reducing the need for more gear. Carriers built up the phone network over the past few years to be ready for an expected growth in services—which has not fully materialized—and to ward off competition from telecom upstarts. Instead, upstart carriers from Winstar Communications to Teligent Inc. have filed for bankruptcy. So the big carriers are slowing construction of their networks.

The bigs are expected to cut their capital budgets across the board. According to Lehman's Bath, Verizon Communications Inc. is likely to cut \$1.4 billion out of its 2002 budget estimates, SBC Communications an equivalent 1.4 billion, BellSouth \$660 million, and Qwest Communications \$1.7 billion. AT&T and Sprint are expected to reduce their capital budgets some \$1 billion each. None of the companies would comment on future plans for spending cuts. BellSouth CEO F. Duane Ackerman, however, did say: "The restraint on capital spending will be pretty significant in 2002. I don't see signs of a turnaround."

WIDE RIPPLES. The worsening telecom depression is bad news for a weak economy. The sector accounted for 12% of U.S. business spending on equipment and software last year. More important, it generated one quarter of the spending increase from 1999. This year's pullback in capital spending is a big reason for the deep job cuts.

Telecoms have wiped out 175,000 jobs from the boards this year up through August, according to outplacement firm Challenger, Gray & Christensen. That's 19% of telecom job cuts and more than any other in the globe industry.

Telecom's added capital-spending woes will reverberate throughout the tech industry. Computer-server maker Sun Microsystems Inc., which derived 60% of its revenue growth from tele-



THE TELECOM MELTDOWN GETS WORSE

Forecasts for spending on telecom equipment are being scaled back big-time. A Lehman Brothers survey found spending will fall to \$82 billion next year, down from \$102 billion this year—which is already a 5% drop from 2000.

OVERCAPACITY Carriers are reducing their spending because the binge investments of the past couple years have resulted in overcapacity. On Aug. 29, WorldCom said capital spending for next year will be \$5.5 billion, or \$1.5 billion lower than this year.

DISAPPOINTING DEMAND Growth markets aren't meeting targets. For example, revenue from high-speed data may increase 15% next year, about half of expectations.

BANKRUPT UPSTARTS The number of upstart carriers going belly-up is growing weekly. Over the summer, high-speed Net access providers Covad Communications and Rhythm NetConnections filed for bankruptcy protection.

INDIGENT ISPs Internet service providers like PSINet are seeking bankruptcy protection. That's a big reason why forecasts for spending on Internet infrastructure have fallen 46% since last year.

ist year, has lost a crucial growth engine. It warned on Aug. 29 that it could miss its first-quarter revenue target. So has contract manufacturer Cestica Inc. It says revenue growth has fallen from 60% a year to 5% to 10% a year, mostly because of telecom.

The new round of cuts could prove to be a catch-22 for carriers. While they need to pare back spending until capacity is in sync with demand, this will delay upgrading their equipment. Down the road, cutting-edge phone networks are essential for new data and wireless services. "In 18 years in this industry, I can't recall a cap-ex cut of this magnitude that did not eventually negatively impact the top line," says CS First Boston telecom analyst Daniel P. Reinhold. Bath disagrees, saying carriers such as Verizon are wise to scale back unnecessary investments.

For now, the new markets aren't living up to earlier expectations. Revenue growth from high-speed data lines will be only 15% next year, about half of earlier forecasts. And on Aug. 20, Lehman wireless analyst John M. Pense lowered long-term revenue expectations for the wireless sector by 10%, down from a current \$17 a month per subscriber to \$12 in 2007.

ACTIONS APLENTY. Carriers are getting a little help in cutting their budgets, thanks to the plummeting price of equipment. Dozens of upstart carriers have gone out of business. Courts are auctioning off equipment that belonged to bankrupt carriers and Internet service providers for 10¢ on the dollar. And the price of optical communications systems is falling as much as 50% a year.

The outlook is similar outside the U.S. Expenditures on telecom gear will decline 2% in Europe, 5.5% in Asia Pacific, and 18.4% in Latin America, Merrill Lynch & Co. warned in August. China Mobile has cut this year's \$5.5 billion capital budget by 15%, to \$4.7 billion.

The question: When will growth be more than a mirage? Lucent Technologies told analysts in August that it expects industry revenues to grow 10% to 12% in 2003. Could Lucent, which appears to have sharply underestimated the problem for 2002, be right about 2003? Susan Kalla of Friedman, Billings, Ramsey & Co. says growth could resume in 2003 but not at the level Lucent predicts. "In the best case, Baby Bell spending [hikes] regress to normal levels of zero to 5%." Once again, the crisis is turning out to be just a mirage on the hot sun.

By Steve Rosenbush in New York, by Roger O. Crockett in Chicago and by Bruce Einhorn in Hong Kong



MICROELECTRONICS CHIEF KELLY SAYS A NEW PLANT WILL MAKE THESE 12-INCH WAFERS BY LATE 2002

SEMICONDUCTORS

IBM ISN'T CASHING IN ITS CHIPS

Unlike rivals, it's forging ahead with big investment plans

For much of the past three years, IBM has been able to count on its chip business as one of the company's few dependable engines of growth. In the second quarter, ended on June 30, revenue for the microelectronics unit, which designs and manufactures slivers of silicon for IBM and other companies, shot up 27%, to \$1.32 billion, according to Merrill Lynch & Co. Indeed, faith in IBM's chip business had been so unshakable on Wall Street that despite the tech slump, Merrill analyst Thomas Kraemer estimated in a June 8 report that sales for the \$3.7 billion division would skyrocket 46% in 2001, contributing nearly 30% of IBM's anticipated \$6.7 billion in revenue growth for the year.

So much for dodging the downturn. On July 18, Chief Financial Officer John Joyce dropped a bomb: Sales of IBM chips could sink 15% to 20% in the second half of the year because of de-

clining orders from communications customers such as Cisco Systems Inc. Networking chips account for up to 40% of IBM's semiconductor business. Worse, Joyce says, IBM's ability to meet Wall Street's earnings estimates in the third and fourth quarters "will, for the most part, be a function of what happens to our microelectronics business."

Big Blue has a lot riding on its chip business. Even though semiconductor accounts for only 5% of IBM's overall revenue, because chip manufacturing has high fixed costs, any revenue shortfall body-slams the bottom line. Sanford C. Bernstein & Co. analyst Toni Sacconaghi, like many other analysts, has lowered his 2001 earnings estimates by 5%, or about \$300 million, primarily because of the sagging microelectronics group. He now expects IBM to earn \$8.32 billion on \$90 billion in revenue this year. Merrill's Kraemer pegs IBM's microelectronics group to grow an ane-



technology

mic 7% this year, to \$4 billion. The stock has dropped 6%, to 102, since the second-quarter earnings announcement. "Nobody projected a down cycle this deep," says John E. Kelly III, the senior vice-president who runs microelectronics. "Hopefully, we'll be the first out of it."

The chip dip is a major blow to Chairman Louis V. Gerstner Jr.'s plan to turn IBM into a tech titan that pumps out cutting-edge inventions etched in silicon. Sure, IBM's \$33 billion services division dwarfs its chip business. But IBM uses the technology to give its own products, such as servers, a leg up, as well as selling chips to others, including rivals Sun Microsystems Inc. About half of IBM's chip sales comes from outside companies.

Chip technology is also helping to build IBM's brand and launch the company into new markets. On Sept. 14, Nintendo Co. will release in Japan its new game console, GameCube, powered by IBM chips—Big Blue's first game chip. Nintendo is so high on the technology, it's putting IBM's logo on the packaging—another first. "It shows we have the best technology in the world," says Genyo Takeda, who managed the game's development.

But technology alone can only help so much. Most analysts say IBM, like the rest of the industry, will not be able to generate growth in its chip business until the middle of 2002, when a chip recovery is expected to begin. Until then, the company is taking small, defensive steps, including scaling back on subcontractors, slowing installation of gear for making chips out of older materials such as aluminum, and trimming the funding of new equipment for networking chips that are used in older routers. When it comes to the newer chip technologies, Kelly is going full-throttle on investments in plant and equipment. "Our strategy is to be ready when this thing comes out," he says.

It's a bold play. While many chip-makers are slashing capital spending, IBM is sticking to its guns. Samsung Electronics, the fourth-largest chip producer, is reducing its budget from \$5.7 billion to \$4 billion this year. IBM, along with Intel Corp., is one of the few standing pat. Kelly says Big Blue will maintain its \$5 billion investment

plan—the largest in IBM's history—in plant and equipment. That includes finishing a \$2.5 billion chip plant in East Fishkill, N.Y., by August, 2002, that will be one of only three in the industry able to make 12-inch wafers. Intel and memory maker Infineon own the other two. The new IBM plant promises to lower the cost of making chips and to allow more complex silicon, since engineers can fit 35% more circuits on the larger wafer. "If anything, I want to do more in a couple of areas," says Kelly.

What are Kelly's big bets? He's making double-digit increases in his investment in new chips for high-growth businesses, including game consoles, wireless communications, and networking markets. "If IBM continues to aggressively invest in chips, it is likely to become a leading player in the digital home-electronics world," says an executive at Samsung, an IBM rival.

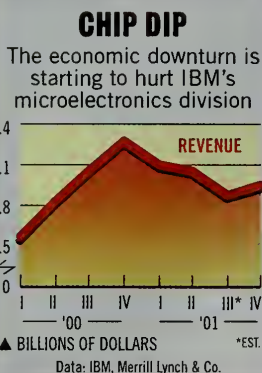
Early signs are promising. IBM has contracts with the two largest videogame manufacturers, Sony and Nintendo, and five large cell-phones companies, including Qualcomm. And it has won 54 deals in the networking-processor market, according to market researcher IDC.

Investing in chip technology has paid off for IBM. With \$3.8 billion in cash and a \$5 billion research budget, the company has been a technological version of Motown Records, turning out a hit parade of chip advances over the

past few years. In 1998, IBM was the first company to mass-produce chips with copper wiring, which runs 30% faster and use less power than the aluminum wires that are in most chips. Last year, IBM introduced a new method for building chips with germanium, which has proven popular with cell-phone makers because the chips use less power. "For at least the next year, they'll have technology to keep them at the cutting edge," says R. Doherty, director of research at Seafood (N.Y.) research firm Engineering Group.

NICHE EDGE. It wasn't always this way. Before 1993, IBM made chips only for its products. Then Gerstner decided to radically change the company's strategy: IBM would sell its technology to other companies—sometimes even before IBM could make use of it. Kelly was one of the managers who helped Gerstner reshape IBM's chip business. In January, 1999, when Kelly became general manager of IBM microelectronics, he spearheaded its exit from the low-margin memory-chip market and put an end to efforts to go head-to-head with Intel in the PC microprocessor market. Instead, Kelly led IBM into premium markets for custom-built chips that handle specific tasks, say, routing data or manipulating video images. Last year, IBM was the world's largest producer of custom-built chips, with \$2.7 billion in revenue and a 12% market share, according to Gartner Dataquest. "I wouldn't trade my head for anybody else's in the industry," Kelly says. Now it's up to him to pay that hand well and get IBM back on the growth track.

By Spencer E. Auer
in New York



IBM INSIDE

Here's how Big Blue plans to turn up the heat:

BUILDING FOR THE FUTURE IBM is pressing ahead with a \$5 billion investment in plant and equipment. That includes plans to open a state-of-the-art, \$2.5 billion chip plant in Fishkill, N.Y., by August, 2002.

CUTTING A SMIDGEN So far, IBM is making minor cutbacks on subcontractors and new equipment for lower-growth networking chips that are used in older routers and switches. It's also slowing installation of gear used to make chips with older materials, such as aluminum wiring.

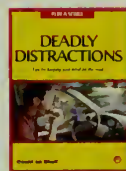
CHASING NEW MARKETS Big Blue aims to grow by supplying chips for such devices as cell phones, set-top boxes, and video-game consoles, hiking those areas' share of revenues from the low teens today to one-third in a few years. A new Nintendo game machine that features IBM chips is due out in September.

DATA: IBM, Gartner Dataquest

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RATING STOCKS,
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Stock Ratings That Won't Give You the Runaround

Which service should you follow? Depends on your style

BY LEWIS BRAHAM

Investors looking for objective advice from Wall Street analysts might as well be searching for Big Foot or Jimmy Hoffa's body. As the bear market has made clear, analysts are often just puppets of their firm's investment banking arm. They almost never say sell on a stock lest they anger a client or potential client. Just consider this: With the economy on the brink of recession, only 1.5% of U.S. stocks have analyst "sell" ratings, according to First Call, a stock research firm. Nearly 65% are still "buys," and 34% are rated "hold."

So where do you get advice that's free of investment-banking connections? It's available on newsstands that sell *Investor's Business Daily*, in the mailbox if you are a *Value Line Investment Survey* subscriber, and online at such sites as

morningstar.com and our own businessweek.com, which carries Standard & Poor's stock reports (S&P, like *BusinessWeek*, is a unit of The McGraw-Hill Companies.) Except for Morningstar, which just launched its ratings system, all have long track records. Recommendations at Value Line, the oldest of the stock ratings firms, have delivered a 19.1% annualized return over the past 36 years, besting the S&P 500-stock index's 14.6%.

Each ratings service takes a different approach. Depending on market conditions and your personal investment style, you might prefer using one instead of another (table, page 44). Stocks that get high marks in the Value Line and *Investor's Business Daily* systems are usually those with a lot of momentum, both in earnings growth and stock price appreciation. Value Line ranks stocks from 1 to 99, with 99 the highest



ings have more than quadrupled, to 9¢ a share in 2001's second quarter from 2¢ a share in the same quarter last year. In market performance, it's outpacing most of the other stocks Value Line covers and beating its Value Line analyst's earnings estimates.

IBD also lauds eBay. Under the IBD's Smart-Select Composite Rating system, eBay ranks high for earnings growth, sales, profit margins, and return on equity, and it does fairly well on stock price performance. The trading-volume indicator is neutral, neither a positive nor negative for the stock. All told, the composite score was 92 out of a possible 99. Anything over 80 is considered a buy—if the market is favorable for buying. (In its column called "The Big Picture," IBD rates the stock market as a whole, and right now its model is saying cash is better than stocks.)

Standard & Poor's is of two minds on eBay. Under the purely quantitative Fair Value system, the company gets a 1, the lowest rating—it's just pricey relative to its prospects. Under the star ratings, it gets four of them, which means investors should "accumulate" stock—i.e., buy, but take your time doing it. Why the stark difference in recommendations? Says Scott Kessler, S&P's Internet analyst: "eBay is one of the few companies in the Internet sector to thrive in a dot-com downturn. It deserves a premium valuation."

Both approaches are noteworthy. S&P says stocks that got a 5 on its quantitative system have beaten the S&P 500 in 9 of the past 14 years. And the analyst-chosen five-star stocks have beaten the S&P 500 index in 10 of the past 14 years. Another useful S&P stat in the quant section is the Earnings & Dividend Rank, which rates stocks from A+ to D on their earnings growth and stability over the past 10 years. In the past 14 years, high-earning A+ stocks performed best in bear markets, while C and D stocks were stronger in bull markets.

So which ratings system should you follow? It depends on your instincts. A savvy analyst may have insights that a rating generated purely from crunching numbers will simply not find. On the other hand, numbers are completely objective. "Our ratings are not based on our opinion or Wall Street's opinion but on investment models that have worked in every market cycle," says IBD founder William O'Neil.

Of course, even black-box models have some subjectivity, since someone has to construct programs that crunch the numbers (page 120). And some models blend all sorts of analyses.

Morningstar's final rating is determined by a quantitative model, but the earnings estimate is made by an analyst. If Kathman incorrectly assessed eBay's growth potential, that skews its Morningstar rating favorably or unfavorably. The same holds true at Value Line, though estimates are much less significant to its model.

Although these ratings firms have no investment-banking ties, potential conflicts exist. At Morningstar, analysts are allowed to own stocks they cover. That could make them overly bullish about a favorite company. Standard & Poor's changed its ownership policy three years ago,

Value Line, S&P, Morningstar, and IBD are largely free of conflicts of interest. That doesn't mean they agree on the prospects of any particular stock

Value Line uses a 1-to-5 system in which a 1 is the most desirable rating.

Morningstar takes a more traditional valuation approach, giving the highest ratings to companies trading at a sizable discount to the value of expected cash flows. A five-star stock is a "strong buy," one star a "strong sell." Standard & Poor's offers two sets of ratings. One, like IBD's and Value Line's, is quantitative and evaluates stocks relative to their fair value on a 1-to-5 scale, with 5 the best. S&P's other ratings system uses one to five stars, with five as the best. S&P Star ratings are based on an analyst's opinion of the stock.

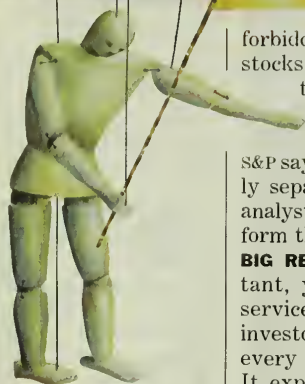
DIFFERENT TAKES. To see how varied the ratings can be, take a look at eBay, one of the few profitable e-commerce stocks. Morningstar gives it only one star. How come? Morningstar In-

ternet analyst David Kathman estimated eBay's annual revenues to line up with an earnings growth projection of 69% through 2005. He

also figured in the company's asset turnover, or how efficiently it uses its assets. Plugging these numbers into a discounted cash-flow model, he arrived at a fair value for the stock of \$40. Since eBay trades at \$55, the company is now 38% overvalued. At Morningstar, anything more than 30% overvalued automatically receives one star; more than 30% undervalued, five.

Value Line has a very different take. It gives eBay a 1 for its Timeliness rating. That means one of 100 stocks that Value Line expects to perform the lower-ranked stocks in its 1,700-stock universe. The reasons? First, eBay's earn-

Stocks



forbidding analysts from buying their covered stocks, but they can hold onto existing positions. S&P's biggest business is not rating stocks but rating bonds for issuers, which could present a conflict, too. But S&P says it keeps stock and bond analysts strictly separated because companies give the bond analysts private information they need to perform their work.

BIG RETURN. While objective advice is important, you should also consider each ratings services' trading habits. If you're a long-term investor who doesn't like checking stock prices every hour, you're better off with Morningstar. It expects its top-rated stocks to reach their target prices in three to five years. S&P's star-ratings outlook is shorter, only six to 12 months. Value Line reruns its Timeliness ratings every week, and IBD every day, so recommendations from those two services have shorter life spans.

Admittedly, IBD's momentum-driven style has produced some spectacular returns. According to IBD's O'Neil, his buy lists generated a 48,133% cumulative return from 1977 (the newspaper didn't start publishing until 1984) through the end of 2000. That compares with a 2,863% return in the S&P 500. Yet O'Neil's calculations are not from an actual portfolio, and they exclude trading costs and taxes.

Breadth of coverage also should be a consideration. By sticking to its purely quantitative approach, IBD can rate more stocks—currently

over 10,000, or 80% of the entire U.S. stock market. By contrast, Morningstar's 25 analysts only cover 500 stocks; S&P's 35 equity analysts, 1,070; Value Line's 70 analysts, 1,700. What's left out are mainly the smallest companies, some of which may offer excellent opportunities.

Depending on your preference, you can access all of these ratings in paper reports or online. Online is more up-to-date, however, which is important if you're using Value Line or IBD momentum systems. A \$197 annual subscription to IBD gets you the daily paper and access to the site, investors.com. Value Line charges \$570 a year for the weekly publications and an additional \$145 for online access. Morningstar's online subscription is \$99 a year.

You can buy S&P reports at businessweek.com for \$5 each, and magazine and Web site subscribers can get three free reports a month. The site's Portfolio Tracker—free to those who register at the site—also gives you S&P Star and Fair Value ratings, but without the complete analyst reports. Or you could subscribe to the Stock Reports section of S&P's AdvisorInsight for \$995 a year. This allows you to screen for top-rated S&P stocks and view as many reports as you like.

No rating can perfectly capture the essence of a company or explain why you should or shouldn't invest in it. But any way you look at it, these ratings services provide more objective analyses than anything you would get from the Street.

Ratings Without Rose-Colored Glasses

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IBM

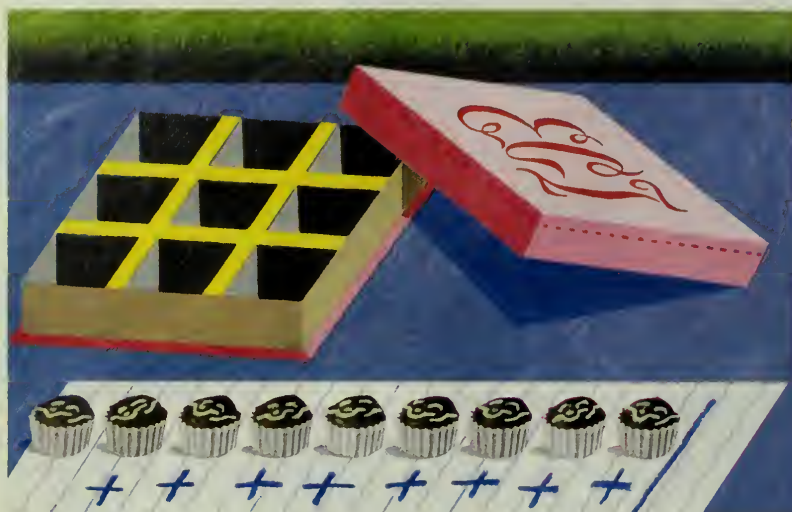
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Labor Costs Tell the Tale

The ECI predicts where profits may be headed

BY KATHLEEN
MADIGAN

This broad
survey of wage
and benefit costs
serves as
a signal for
the Fed and
Wall Street

This is the 12th in an occasional series showing how major economic reports can affect the stock and bond markets

Without even thinking about it, you can probably reel off your annual salary. But do you know the value of your benefits? Likely not. Yet benefits make up a big chunk of your compensation—and are a significant cost to any business.

Amid the current dismal outlook for profits, Wall Street is especially interested in labor costs since rising pay could mean even greater declines in profits. That's why investors should pay attention to the Labor Dept.'s Employment Cost Index, a quarterly measure of what companies spend on wages, salaries, and benefits.

Federal Reserve Chairman Alan Greenspan has indicated he watches the ECI to gauge profits, and for good reason, says Maureen Allyn, chief economist at Scudder Kemper Investments: "The ECI is the most comprehensive measure of labor costs. It gives the best sense of rising cost pressures being felt by businesses."

Certainly, other factors affect earnings. The sudden dropoff in demand, along with rising energy costs and the strong dollar, caused profits to swoon in the first half. But labor costs account for two-thirds of the average company's expenses, so they have a big impact on the bottom line. Right now, the ECI shows that employment costs rose 3.9% in

the year ended in June, down from a 4% advance a year earlier.

In addition, some economists watch the ECI as a harbinger of inflation pressures, so the index also affects bond prices. Inflation hawks, including those at the Fed, are warning about potential price pressures in early 2002, when the economy is expected to rally. Some worry that jumps in health insurance premiums could cause trouble. So, expect the ECI to play a role in setting monetary policy. If health-care or other costs accelerate, the Fed will be less likely to cut rates further.

The ECI tallies up what companies, state and local governments pay their workers in wages, salaries, and benefits for each hour worked. Though there are other gauges of labor costs (table), the ECI has a few advantages. It covers more work than the hourly wage series and is more timely than the compensation data in the Labor Dept.'s Productivity and Cost report. Most important, "it's hard to get a read on benefits anywhere else," says Allyn. If benefits are pricey. According to a separate annual survey done by Labor, benefits account for 27% of all labor costs.

To calculate the ECI, Labor surveys about 7,400 private companies and 800 state and local governments. The questions cover hourly pay and straight salary, and benefits ranging from overtime, health insurance, and paid vacations to Social Security taxes and workers' comp. Labor releases the report on the first Thursday of the month following the quarter's end. You can get it at www.bls.gov/news.release/eci.toc.htm.

With revenues expected to be weak at least into 2002, any profit gains will likely come from cost-cutting. So keep an eye on the ECI to get the best sign that Corporate America is holding down labor expenses. A rosier profit outlook should give a big lift to your portfolio.

The Skinny on Payroll

A list of government reports on compensation

EMPLOYMENT COST INDEX A quarterly series by the Labor Dept. The ECI covers wages, salaries, and benefits of all employees working in the private sector and state and local governments. Labor costs are calculated per hour worked and then indexed to a base year of 1996.

PRODUCTIVITY & COSTS Within Labor's closely watched Productivity Report are data covering the growth of compensation for each hour worked. Unlike the ECI, this compensation series includes stock options and is used to calculate unit labor costs, or the cost of labor to produce each unit of output from a motor vehicle to a bank transaction.

HOURLY WAGES Included in Labor's monthly employment report. This wage series tracks the hourly pay of production and nonsupervisory workers (about 80% of the workforce) across a breadth of manufacturing and service industries. Also tallies up overtime pay in manufacturing.

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A FEMINIST ICON REFLECTS ON MONEY



BY TODDI GUTNER

hers@businessweek.com

Gloria Steinem talks about the financial progress women have made and analyzes her own strengths and weakness in managing her assets

Discussing women and finances with Gloria Steinem, the 67-year-old activist and author who helped ignite the 1960s feminist revolution, is like participating in a seminar on the recent history of women in our economy. "The women's movement has always been one of finances, but it has taken different forms," says Steinem, who spoke to me at her Manhattan duplex last month.

How did the women's movement first address the subject of money and finances?

Back during the Suffragist Era, women used to be the property of their husbands or fathers. The movement fought for the women's right to own property and retain their own salaries. That was certainly financial.

What happened in the next phase?

The second wave, which began in the 1960s, was about self-sufficiency, the right to earn money, and the ability to support oneself in the paid labor force. Out of that came the emphasis on equal pay for equal work. Then came comparable worth. That's where you don't just look at the job per se, but a comparable position in terms of training, experience, and skill level. Obviously we don't yet have equal pay, and we certainly don't have comparable worth. We've narrowed the gap, but we still have more to go.

Where do you think the movement is now with regard to women and money?

What is beginning to enter the public consciousness now is the way in which money is passed down. Concentrations of wealth are passed down in this culture in a very biased way. The widows are almost never in control of what passes through them. It usually goes to the son or under

professional control. But women in families inherited wealth are beginning to prevail and take control of their money and break the trust. It takes a lot of courage to do that, to address not just the problem of economic equality, but to do it inside your own family.

What about women who don't inherit wealth?

More and more women are starting their own businesses after being treated with such equality in the paid labor force that they hit the glass ceiling, got stuck in the pink-collar ghetto, or couldn't adapt their schedules to the need to raise kids. But access to capital is still a problem for women.

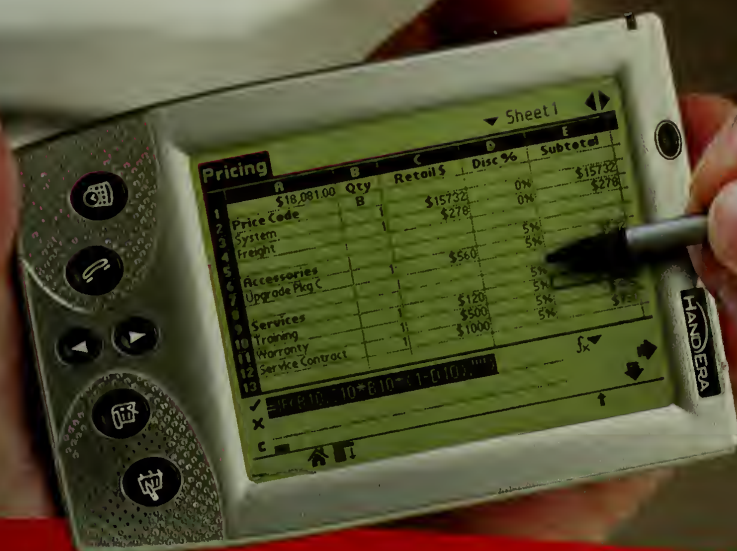
What can we do to change that?

We need to invent new ways of moving money. For instance, communal capital, like the women buying a florist shop together. The



MARITAL ASSETS: Steinem and spouse keep their finances separate

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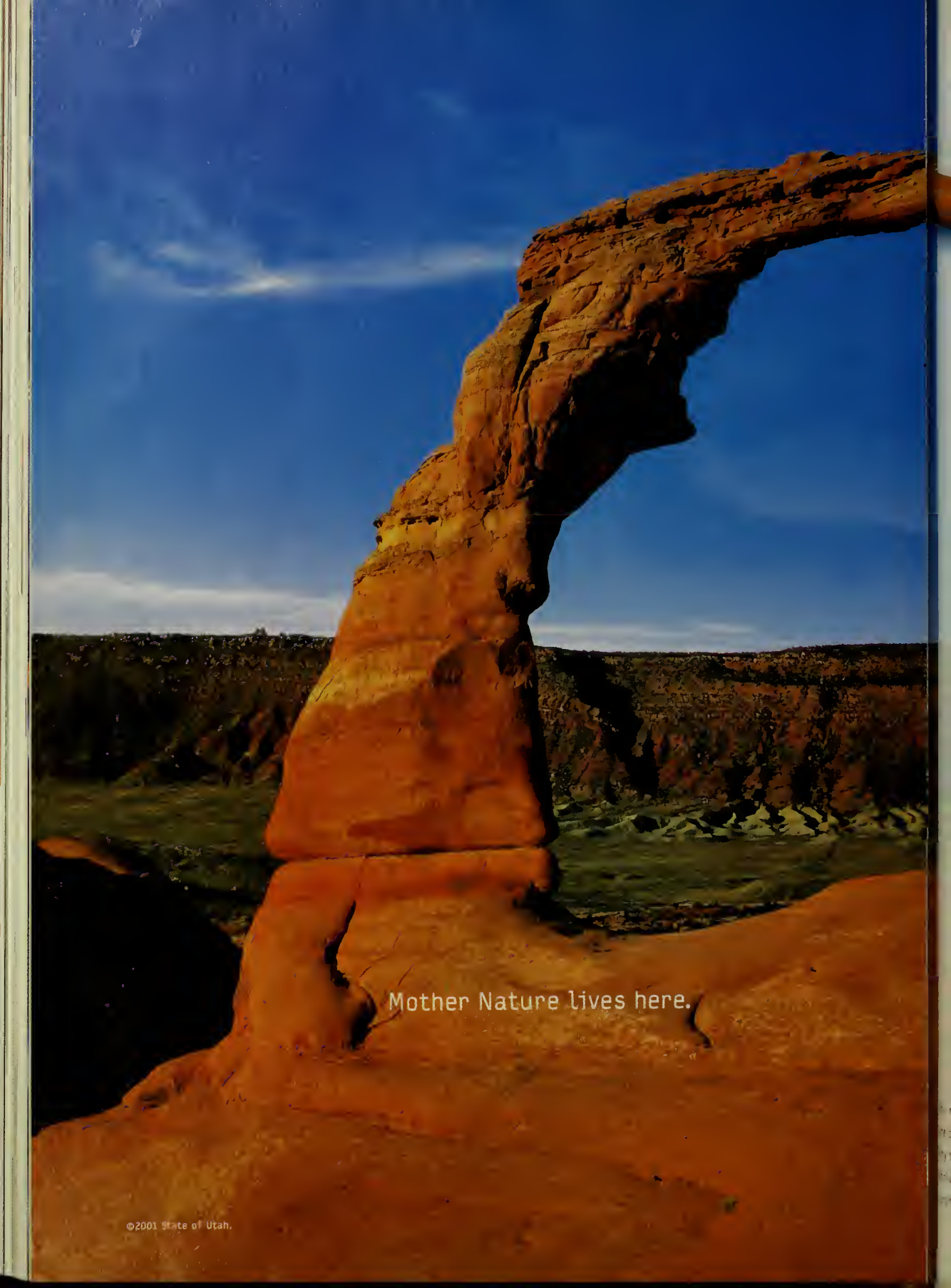
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How to tell a cry for help from an act of defiance.

IT'S NOT EASY, and sometimes it takes a professional team to recognize a signal—like unmatched socks.

Amy (not her real name) was a veteran of homeless street life where you steal to survive. She was eight when she was abandoned by her addict mother.

She was hard to be around. Not that she was vicious or violent or anything like that. Instead, she was uncomfortably odd. She made strange faces and hand gestures, had a stilted walk, peculiar mannerisms and an unnerving way of talking too close to your face.

Her deliberately assembled daily costumes (always including her trademark mismatched socks) were over the top. Eight-year-old girls are entitled to wide latitude for fashion peculiarities, but the aggressive nature of Amy's personal dress separated her from the rest of the world. She managed to disturb people before she ever spoke a word, and adults and children alike did their best to avoid her.

Enter Sunny Hills Children's Garden

That was when Amy came to our Group Home Program. Each year, Sunny Hills Children's Garden gives a full spectrum of services to 400 emotionally traumatized children, teens and their families. They come from nine Bay Area counties and all over California, for reasons as varied as the individuals themselves. We help them rebuild their lives in a program



SUNNY HILLS CHILDREN'S GARDEN

300 Sunny Hills Drive in San Anselmo, with additional facilities in San Rafael and Novato. The Bargain Box is at 508 Irwin in San Rafael. If you'd like to know more about Sunny Hills Children's Garden, call us at 415-256-1580 or log on to www.shcg.org to find other ways to help



that includes group homes, schools and day treatment. The one common element is a stable, homelike environment.

The breakthrough

For Amy, our answer came when we recognized her behavior as talent struggling to come out. We enrolled her in a local drama program and covered the cost out of our Special Needs Fund. She channeled her "oddities" into acting and almost miraculously, the light bulb went on over her head.

She changed her attitude about life and tried to fit in. She told her teachers she no longer needed to be different and even modified her dress and behavior. She was suddenly ready to do what she had to do

to move on from the program and re-enter the world.

She went back to public school. Last May, she graduated from Sunny Hills Children's Garden and is now happily reunited with her relatives after years of separation. Her public school teachers tell her that she gets along just fine. The socks? Pretty much history. As she puts it, "I only wear socks that don't match when I feel I don't fit

A painless way to help 400 other Amys, right now

Just clean out your closet, unmatched socks and all. Bring whatever you're passing along to our Bargain Box Thrift Shop in San Rafael and while you're there, check out whatever we have for sale.

Yes, there are other thrift shops around, and there may be one closer to you. But none of them can do what we did for

X =



- ▶ Do your children know why education is important?
- ▶ Do your children know how to communicate effectively with adults and with their peers?
- ▶ Do your children consider their options and weigh the consequences before they make decisions?
- ▶ Do your children know how to set and achieve reasonably attainable goals?
- ▶ Are your children able to critically analyze messages from the media?
- ▶ Are your children able to articulate their strengths?
- ▶ Do they know how to use their strengths to overcome their weaknesses?
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"My father was the financially irresponsible member of the family, always getting into debt. My mother was the worrier. I'm a little bit of each"

are a variety of women who come together as venture capitalists, or as angels to women who own their own businesses. We need much more of that.

Do you think the women's movement has stressed how important it is for women to take financial responsibility for themselves?

I think money in the form of a salaried job, "a room of one's own," and independence has been superemphasized by the women's movement. The accumulation of wealth has been less emphasized, perhaps because a lot of feminists came out of the left, as I and others did. The dominant idea now is to take control of our own financial lives, to achieve security and freedom, but not to become like the rich guys for whom no amount of money or power would be enough.

Women are trying to redefine power as control over our own lives, not control over others. So, yes, I think we emphasize financial independence enough, but perhaps not enough about planning for the entirety of our future.

How did your family handle finances?

My father was the financially irresponsible member of the family, always getting into debt. My mother, on the other hand, was the worrier, the responsible one. I'm a little bit of each. He taught me to live with insecurity, which is why I could become a writer and a feminist organizer, and she taught me to remember that disaster could strike.

What kind of investments do you have?

I have never invested in the stock market, mostly because I never had any money. I had just enough to live on for 60 days at a time. We do absorb what our families have done, and people in my family invested very little in the stock market.

If they did invest, it was to buy property after the war (World War II). I follow my father's philosophy, which is to never buy anything that you can't sell for more—mostly antiques or objects of art. My father was an antiques dealer and he taught me to find value in assets. I've never owned a car, but I own my apartment.

Do you have a retirement account?

I do save for a pension fund, which is invested by a woman friend. It was a big financial stepward maturity for me to create a pension fund, which I started when I was well into my 50s. I could have done it sooner.

Do you have any of the typical issues surrounding women and money, such as aversion to risk and difficulty making financial decisions?

I have a tolerance for risk, certainly. And while I'm not comfortable with making financial decisions, I am bothered by the detail. I just don't pay attention, except to make sure the pension fund is in good hands.

You recently got married. How do you and your husband, David Bale, handle your finances?

We keep our finances separate. We often find ourselves arguing over when it is to pay for this or when we go out, and each one insists it's their turn. In the far, there hasn't been a difficulty. We're just starting to talk about estate planning, but haven't done as much as we should. We have made out a joint income-return yet—or even figured out whether we should. We will have to talk to the accountant and see what makes sense.

Are you confident about your financial security in retirement?

I had thought I was going to end up as a bag lady, in my response to this fear that I could always turn around and organize the other bag ladies.

Now, however, I don't think that anymore. I no longer fear I'll end up on a street corner somewhere.

Since I've had a pension fund, I've changed my state of mind. I feel comfortable and confident that I'll never retire. That's because I feel that I have never really had a job. I've been working on what I care about, and some of it has been a source of income.



Gloria Steinem

BORN Mar. 25, 1934. Toledo

EDUCATION BA Government, Smith College 1956

CAREER ACCOMPLISHMENTS Being a political organizer. Founding editor, *Ms.* magazine

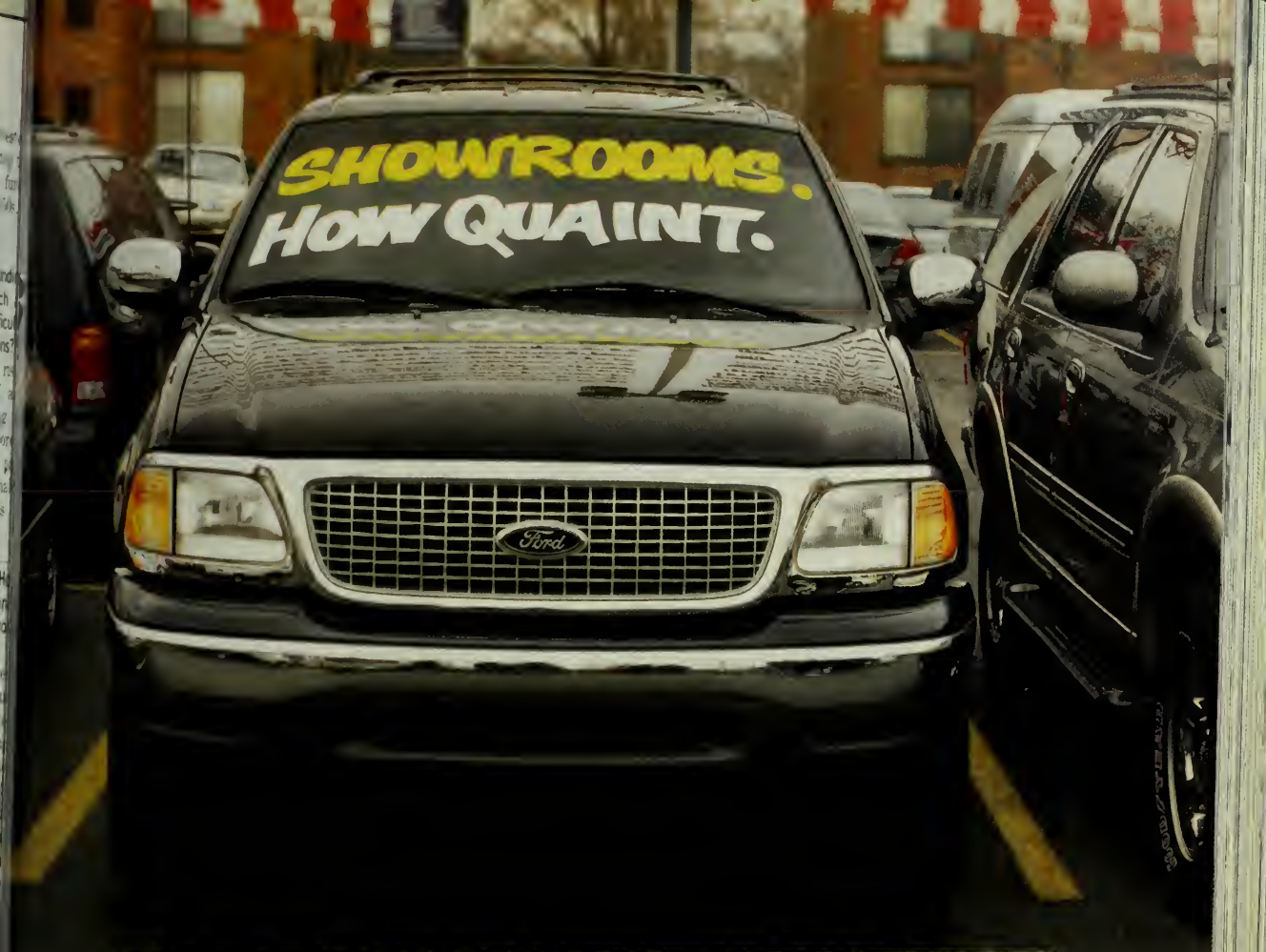
RESIDENCES New York, N.Y.; Manhattan Beach, Calif.

BOOKS *Revolution from Within*, *Outrageous Acts & Everyday Rebellions*

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A MERIT BADGE FOR STOCKSCOUTER



BY ROBERT BARKER
rb@businessweek.com

A free research tool offered by Microsoft's MSN, StockScouter boasts an eye-catching record and ranks 6,500 issues based on a 1-to-10 scale

The implosion in Internet stock trading has rendered at least one happy result:

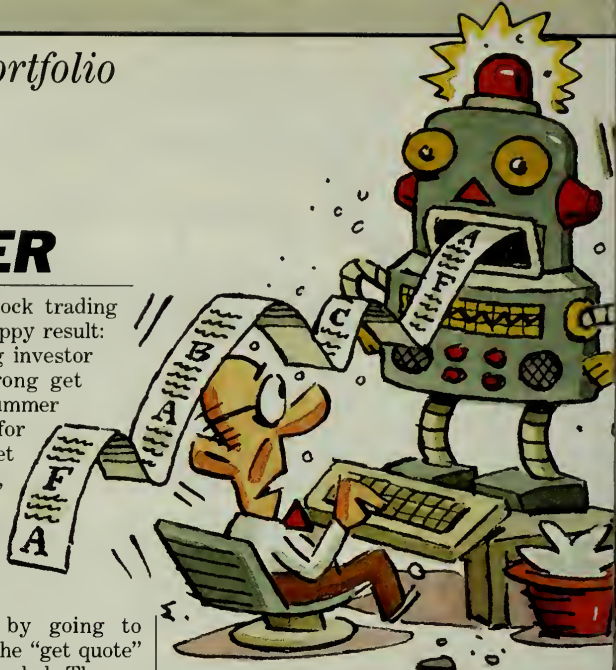
As the weakest links among investor Web sites say goodbye, the strong get stronger. When CNBC.com this summer collapsed into Microsoft's MSN, for example, MSN users began to get timelier news. Better yet, CNBC.com's ex-users now may be tuning into MSN's superior free research tools. The latest is called StockScouter, and it's worth checking out.

You can find StockScouter by going to www.msn.com, scrolling down to the "get quote" window, and entering a ticker symbol. The resulting page will give you a stock price, but you'll also see a 1-to-10 "StockScouter Rating" (10 is best). For instance, the other day it rated Microsoft shares a mediocre 6—"expected to match the market over the next six months with average risk." Stock in archrival AOL Time Warner received a 7. PepsiCo got a 10, General Electric an 8, Ford a 5, Cisco Systems a 4.

How can StockScouter predict the next six months? It can't, naturally, but it boasts an alluring record. Microsoft says that over the past 10 years, a 50-stock portfolio run according to the model would have risen 13.3% over the average six-month period, while the Wilshire 5000 Total Stock Market Index rose 5.4%. However, that does not include trading costs, which might cut annual returns by one to two percentage points as the portfolio turned over nearly twice a year.

Behind StockScouter is Camelback Research Alliance, a Scottsdale (Ariz.) investment boutique. The firm got its start analyzing data on trading by corporate insiders, one of four areas scanned by StockScouter. The others are fundamentals, such as estimated profit growth; valuations, such as price-sales ratios; and such technical indicators as relative price strength. In all, Camelback looks at 10 factors after each trading day to rate 6,500 U.S. stocks by the next morning for their potential return, adjusted for risk.

If this were a winning Powerball ticket, Camelback would not sell it to Microsoft—and Microsoft would not give it away at MSN. And



just because the model would have clicked the 1990s doesn't mean it will now. Lange Wheeler, president of Numeric Investors, a pioneer in quantitative stock-picking models, also warned me: "I would be cautious about using this to go cherry-picking one or two stocks."

Just the same, StockScouter analyzes far more data than most people can hope to for six stocks let alone 6,500. It yields daily lists of top-rated

stocks, both over and in subsectors (table). Best of all are the details given in its reports on each stock—good food for thought if you give your portfolio a checkup or search new stocks.

Take Krispy Kreme Doughnuts, a stock I consider curiously overpriced. StockScouter rates it a 4. I find one possible explanation: Institutions have been accumulating the stock. Similarly, I've noticed Uniphase trading lately below \$7. A bargain? to StockScouter, which gives it a 4, partly because analysts are cutting profit estimates.

StockScouter's opinion on these stocks did not necessarily change mine, not least because it's based on a relatively near, six-month horizon. But the best investors not only consider but actively seek out evidence that's potentially contrary to their hypotheses. StockScouter is objective, fast, and free way to do just that.

Some MSN Picks...

OVERALL FAVORITE STOCK	Barr Laboratories (BRL)
FAVORITE SMALL-CAP	GulfMark Offshore (GMRK)
FAVORITE SECTORS	Finance, Public Utilities

...And Pans

OVERALL WORST STOCK	Sense Technologies (SNSG)
NEXT WORST	Digital Lava (DGLV)
WORST SECTOR	Technology

As of Aug. 30 Data: MSN

BusinessWeek online

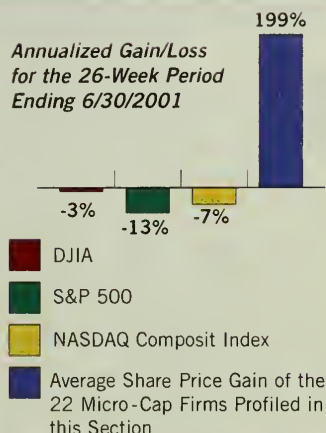
For barker.online, go to www.businessweek.com/investor/ and click on "Column"

THE EQUITY INVESTOR'S 26-WEEK MICRO-CAP REVIEW

SELECTED PROFILES OF THE NATION'S TOP PRICE-PERFORMING MICRO-CAP COMPANIES AS OF 6/30/01

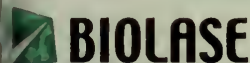
From the approximate 5,300 domestic companies with market capitalizations under 200 million dollars, the following pages highlight selected firms in the top 10%, in terms of share price performance for the 26-week period ending 6/30/01. Each profile describes a leading company including its industry, market trends and reasons for success, as written by company management. And while past performance is never a guarantee of future results, these top-performing companies represent investment opportunities worthy of a micro-cap investor's close consideration.

Annualized Gain/Loss
for the 26-Week Period
Ending 6/30/2001



BIOLASE Technology, Inc. • BLTI • Medical Device

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Key Manager Statement

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Jeffrey W. Jones,
CEO and President

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Key Manager Statement

"Our business model is succeeding in a difficult marketplace. The steps we have taken in developing our channel, our brand, and, ultimately, the reach of the Switchboard directory platform, position Switchboard to achieve its goals. The forces that will drive the growth of the online directory market are aligning with Switchboard, validating that the Switchboard directory platform is indeed becoming the industry standard."

Doug Greenlaw, CEO

US Liquids • USL • Liquid Waste Management

Houston, TX • IR Contact: Earl Blackwell • 281-272-4500
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US Liquids is the North American leader in liquid waste management services, including collection, processing, disposal and recovery of a myriad of liquid waste streams, including wastewater, hazardous waste, oilfield exploration and production waste, paints, household hazardous waste, grease trap waste, beverages and pharmaceuticals.

Key Manager Statement

US Liquids has grown by acquiring and consolidating small, independent waste companies into one cohesive organization. With 42 permitted facilities, USL is fully qualified to handle hazardous and non-hazardous liquid waste streams. USL not only processes and disposes of liquid waste, but also recovers and recycles valuable resources from the waste.

"Originally, we harvested resources and managed wastes. Now, and in the future, we must manage resources and harvest waste. Water is going to become our most critical resource in the future. And, as the regulations regarding wastewater continue to tighten, that bodes well not only for us but for the industry and public as a whole."

Mike Lawlor, CEO

First Cash Financial Serv., Inc. • FCFS • Consumer Lending

Arlington, TX • IR Contact: Rick L. Wessel • 817-460-3947
www.firstcash.com



First Cash Financial Services is the third largest pawnshop company in the United States. In addition to its 105 pawnshops, the Company owns and operates 45 check cashing/payday loan locations and has a 50% interest in 55 kiosks located inside convenience stores. The Company's net income and earnings per share increased 57% and 54%, respectively, during the first six months of 2001 compared to the same period of 2000. Based upon current business trends and new store openings in 2001 (10 check cashing/payday loan locations and 25 convenience store kiosks), the Company expects financial results to continue to improve for the near term. The Company has been realizing increases in net income, earnings per share, retail margins, and loan volumes, while reducing debt levels. With the recent slow down in the economy, it is believed consumers will continue to turn to lenders and value based retailers, such as First Cash, for additional consumer financing and bargains. Many investors consider First Cash to be a "recession proof" company and that its industry will thrive in an economic slowdown.

THE EQUITY INVESTOR'S 26-WEEK MICRO-CAP REVIEW

Graphic Packaging Corp. • GPK • Packaging Mfg.

Golden, CO • IR Contact: Paddy Broughton • 720-497-4728
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Graphic Packaging is both a market share leader and the fastest-growing company in the folding-carton business, making one of every three frozen and dry food cartons found in your freezer and pantry.

The firm has enjoyed a CAGR of 48% in revenues since 1996, reaching \$1.1 billion last year. The strong growth has been driven by strategic acquisitions, strong blue-ribbon customer relationships averaging more than 14 years and diversity of value-added products. Debt has been reduced by about 50% since a major acquisition in mid-1999. Graphic Packaging is focused solely and successfully on the folding carton segment of the packaging industry.

Key Manager Statement

"We remain firm in our vision to be the undisputed leader in paperboard packaging. We will achieve our goal by continuing to reduce debt, improve margins, invest in our people and plants, leverage the best practices of our most efficient plants, and by winning and retaining customers with the very best products and service at competitive prices."

Jeffrey H. Coors, President & CEO

Standard Management • SMAN • Financial Services

Indianapolis, IN • IR Contact: Gerald R. Hochgesang • 317-574-5221
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Standard Management

5-Year CAGR*

Sales/Premium Deposits.....	50%
Operating Earnings.....	74%
Assets.....	25%

* Compounded Annual Growth Rate as of Dec. 31, 2000

Key Manager Statement

"While we at Standard Management are pleased with our 5-year track record, we are more excited about our future prospects. We continue efforts to broaden our reach within the financial services industry. Our long-term goals remain unchanged; to increase EPS and sales at a 25% compounded annual growth rate and to increase operating return on shareholders' equity to 15%."

Ronald D. Hunter
Chairman, President & CEO

LendingTree, Inc. • TREE • U.S. Diversified Financial

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LendingTree LendingTree, Inc. is the leading exchange and technology provider for online lending. The company attracts consumer demand through www.lendingtree.com and private-label or co-branded exchanges powered by the Company's technology, Lend-X™. LendingTree also provides access to other services related to home ownership, including a network of real estate brokers.

The LendingTree exchange currently has more than 130 lenders, including six of the top ten U.S. banks, and has facilitated more than \$10 billion in closed loans since inception. The growth opportunity in online lending remains tremendous, as online lending in 2000 represented only 2% of the \$2 trillion consumer lending market.

Key Manager Statement

"We continue to make great strides toward our short-term goal of reaching profitability during Q1 2002. Industry growth, coupled with a relentless focus on our mission and bottom-line results, will enable us to achieve our long-term goal of being the dominant lending exchange and yield additional value for our shareholders."

Douglas Lebda, Founder & CEO

Quaker Fabric Corp. • QFAB • Upholstery Fabric

Fall River, MA • IR Contact: Paul J. Kelly, VP & CFO • 508-646-2255
www.quakerfabric.com



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Key Manager Statement

"Quaker has been steadily taking domestic market share and building its international position over the past few years, as our customers turn to us for both product leadership and outstanding service. We are confident that our superior product service will allow us to achieve strong financial performance and greater shareholder value over time."

Larry A. Liebenow, President & CEO

CollaGenex Pharm., Inc. • CGPI • Specialty Pharm

Newtown, PA • IR Contact: Nancy C. Broadbent, CFO • 215-579-7300
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pharmaceuticals

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Key Manager Statement

"CollaGenex is at an exciting inflection point in its history. Periostat sales growth has been accelerating as a result of direct-to-consumer advertising. Metastat and Dermostat are showing great promise in the clinical potential treatments for metastatic cancer and acne."

Brian M. Gallagher, PhD
Chairman, President & CEO

Nestor, Inc. • NEST • High-Tech

Providence, RI • IR Contact: Carolyn Beaudry • 401-331-9640
www.nestor.com



Nestor, Inc., through its subsidiary Nestor Traffic Systems, Inc. (NTS), is an emerging leader in the traffic management and safety industry.

NTS applies its patented video image-processing technology to red-light enforcement and intersection safety, as well as to the detection of risks at highway-rail grade crossings. Due to the market opportunities and growing momentum for NTS' solutions, Nestor has shifted its focus from financial services/fraud detection to concentrate on traffic safety. NTS' products have been selected by law enforcement, city governments and departments of transportation in CA, FL, IL, IA, KS, RI and VA.

Key Manager Statement

"NTS' video technology not only automates red-light enforcement but enhances intersection safety at the same time. Our unique collision avoidance feature can invoke a red-light delay for cross traffic, helping to prevent broadside collisions with red light runners. In each installation, we're improving traffic safety, one intersection grade crossing at a time."

David Fox, President & CEO

THE EQUITY INVESTOR'S 26-WEEK MICRO-CAP REVIEW

NovaStar Financial, Inc. • NFI • Mortgage Finance

Nestwood, KS • IR Contact: IR@NovaStar1.com • 913-362-1090
www.enovastar.com



Key Manager Statement

"Company performance exceeded internal expectations as employees in our production and servicing operations continue to lower costs at an accelerated pace. High return investments we made in previous quarters have started to materialize in the Company's income statement. We believe that this past quarter is the start of a period of strong earnings performance, based on the high returns in the existing portfolio, and the anticipated returns created from our low cost origination platform."

Scott Hartman, Chairman & CEO

NovaStar Financial, Inc. is non-convincing residential mortgage originator portfolio investor. The Company provides loans for individuals or families who do not qualify for conventional lending programs through a network of 6,300 independent retail mortgage brokers. In the 2001 second quarter NovaStar set record loan production of \$349 million, record earnings of \$4.2 million or \$0.13 per diluted share and declared a dividend of \$0.13 per share on both its common and preferred stock.

CIMNET, Inc. • CIMK • Software Manufacturing

Robeson, PA • IR Contact: John Richardson • 610-693-3114
www.cimnetinc.com



Key Manager Statement

"We are pleased with our track record and the successful integration of Real Time Information Systems. Our future is exciting and we believe that the pending equity investment in Cimnet by Power Systems division of GE and the addition of a GE nominee to our board of directors will enhance our ability to meet or exceed our objectives. Our MES software provides a solid foundation for manufacturing companies to integrate their factories with the supply chain."

John Richardson, CEO

CIMNET, Inc. develops, markets and integrates software for manufacturing facilities. CIMNET's Manufacturing Execution Systems software helps companies create a paperless environment by electronically scheduling and monitoring workflow in real time, allowing for reduced operating costs by improving quality and throughput of products. CIMNET's proprietary products, Folders™, Infolink and DNC Professional™, are used by discrete and process manufacturers in the aerospace, automotive, medical device, food and beverage and consumer packaged goods industries.

IntegraMed America, Inc. • INMD • Health Care Svcs.

Purchase, NY • IR Contact: John Hlywak • 914-251-4143
www.integrated.com



Key Manager Statement

"We intend to expand the IntegraMed Network to cover the 50 largest U.S. markets. This focus will allow the Company to efficiently offer products and services to leading medical providers and to most infertile couples in the U.S. and will provide opportunities for continued long term growth and development."

Gerardo Canet
President & CEO

IntegraMed America is the leading diversified fertility company offering products and services to consumers, providers, payers and manufacturers in a \$2.5 billion industry. The IntegraMed Network is comprised of twenty-two fertility centers across the country, a specialty mail order company, a financing subsidiary and a research institute. With no well-organized competition, the Company has grown significantly over the last five years, has raised approximately \$5 million annually and has repurchased 45% of the outstanding stock. An expanded product line coupled with sixteen years of experience in the fertility industry position IntegraMed well for the future.

International Smart Sourcing, Inc. • ISMT • Manufacturing

Farmingdale, NY • IR Contact: Arthur Meyers, CFO • 888-235-0500
www.smart-sourcing.com



Key Manager Statement

"Our market is growing rapidly because of the tremendous bottom line impact that we deliver to our customers. We are proud of our systems and the people behind them. ISS works very hard to deliver high quality products for our customers and it shows in our customer retention rates. This is a key time for our services and we are looking forward to the challenges and opportunities."

Andrew Franzone, CEO

International Smart Sourcing, Inc. serves a diverse group of small to midsize manufacturers by facilitating cost reductions in their manufacturing operations. To do this, ISS has partnered with a variety of manufacturers in China. These manufacturers specialize in injection molding, printed circuit board fabrication assembly, metal stamping, and machining. Proprietary operating systems allow ISS to maximize production efforts of its customers. This complete turnkey service allows their customers to reallocate capital to other areas of their companies where they feel their ROI is greater.

Spartan Motors, Inc. • SPAR • Specialty Vehicles

Charlotte, MI • IR Contact: Mary Ann Sabo • 616-233-0500
www.spartanmotors.com



Key Manager Statement

"We are committed to being the market leader in the niches where we operate. Our commitment to innovation allows us to continue to take market share from commercial manufacturers, as well as from other custom manufacturers. The initiatives launched at Spartan Motors over the past two years continue to translate into earnings growth."

John Szykiel, President & CEO

Spartan Motors is a leader in the engineering, design and production of chassis for RVs, fire trucks and ambulances. Engineering driven and customer focused, Spartan and its 4 subsidiaries manufacture chassis and frame components to manufacturers of specialty vehicles; it also designs and builds custom fire trucks and ambulances. The firm partners with OEMs such as Fleetwood, Winnebago and Newmar to develop technology that allows vehicle manufacturers to differentiate their products. The shift to a new value-added financial model, combined with operational improvements, generated \$17.2 million in profit and drove improved net earnings and margin in the first half of 2001.

Earth Sciences, Inc. • ESCI • Environmental Tech.

Littleton, CO • IR Contact: Kathy Lowsley • 888-822-8618
www.earth-sciences.com • www.adaes.com



Key Manager Statement

"Concerns over clean air and the nation's energy supplies have focused attention on our suite of proprietary chemicals. Along with outstanding growth from existing products, we expect to be a major player in mercury emissions control. DOE reports estimate that when regulations are fully implemented, this will be a \$2—5 billion per year market."

Mark H. McKinnies, President

ESCI's major operating unit ADA-ES is an environmental technologies and specialty chemicals company helping electric utility companies remain competitive while meeting environmental regulations. Recent announcements include:

- Nation's First Full-Scale Mercury Control Tests Show Promise
- ESCI and NORIT Americas Inc. to Jointly Develop Mercury Control Market
- ADA-ES & Arch Coal, Inc. Sign Co-Marketing Agreement
- ESCI Ahead of Schedule to Achieve Profitability in 2001
- Receive Prestigious Award for Air Pollution Control Technology
- DOE Selects ADA-ES for \$6.8M Mercury Control Program

THE EQUITY INVESTOR'S 26-WEEK MICRO-CAP REVIEW

CHAD Therapeutics, Inc. • CTU • Medical Devices

Chatsworth, CA • IR Contact: Earl L. Yager • 818-882-0883
www.chadtherapeutics.com



CHAD Therapeutics, Inc. is a leading producer and distributor of a full line of cost efficient, user friendly home oxygen systems for use by pulmonary patients who need supplementary oxygen. Provided through an extensive network of homecare providers, as well as global distributors, CHAD's innovative products allow home oxygen patients the mobility and freedom to maintain an active and healthy lifestyle. The cost efficient design of these state-of-the-art products allows homecare providers - who supply home oxygen patients - to increase profitability.

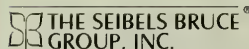
Key Manager Statement

"Sales for the quarter ended June 30, 2001, increased by 63% over the previous year's comparable quarter demonstrating that our turnaround strategy is producing positive results. The sales increase is being led by domestic sales of the Company's new OXYMATIC® 400 series conservers, which were introduced during our fiscal year ended March 31, 2001, and domestic and international sales of our TOTAL O2® Delivery System."

Thomas E. Jones, President & CEO

The Seibels Bruce Group, Inc. • SBIG • Insurance

Columbia, SC • IR Contact: Kenneth W. Marter • 803-748-2767
www.seibels.com



Building Relationships Since 1869

1869, Seibels Bruce is committed to providing quality customer service, building strong customer relationships, developing and capitalizing on territorial knowledge and fostering the creativity and innovation of its people.

In the last year, the Company's financial results improved from a loss of \$21.6 million in the second quarter of 2000 to four consecutive quarters of profitability, resulting in greater shareholder confidence and increased stock price.

The Seibels Bruce Group, Inc. is a provider of property and casualty insurance products and related services. Tracing its roots

Key Manager Statement

"We are pleased that the strategy we implemented in the second quarter of last year is working and are optimistic about the future of Seibels Bruce. The recent performance of our stock emphasizes our commitment to focus our efforts on profitable businesses to provide value to our shareholders."

Jack Natili, President & CEO

Maxcor Financial Group Inc. • MAXF • Financial Svcs.

New York, NY • IR Contact: Roger Schwed • 212-748-7000
www.maxf.com



Maxcor Financial Group Inc., through its Euro Brokers entities, is a leading inter-dealer broker of money market instruments, derivative products and selected fixed income securities for many of the world's largest financial institutions. The Company operates out of the financial centers of NY, London and Tokyo and generates annual revenues in excess of \$150 million.

Key Manager Statement

"Our focus on growing revenues and improving profit margins paid off with 12% revenue growth and back-to-back quarters of record earnings in the first half of 2001. We intend to maintain this emphasis and leverage our extensive and sophisticated global infrastructure - which includes the Tradesoft® electronic trading and processing system - to expand our market share and add new businesses."

Gilbert D. Scharf, Chairman,
President & CEO

	1Q2001	2Q2001
Net Income	\$2,344,282	\$2,718,919
Earnings Per Share	\$0.30	\$0.35
Book Value Per Share	\$3.83	\$4.29

Southern Energy Homes, Inc. • SEHI • Home Mfg.

Addison, AL • IR Contact: Keith Brown • 256-747-8589
www.southernenergyhomes.net



"Our Family Builds Homes for Your Family." Southern Energy Homes, Inc. is a vertically integrated manufacturing housing company which produces and retails

high-quality manufactured homes, provides retail financing through a joint venture and operates 3 component supply divisions. The Company produces manufactured homes sold primarily in the southeastern and south-central U.S. The firm operates 5 manufacturing facilities (4 in AL and 1 in TX) to produce homes sold in 18 states. The homes are marketed under 4 brand names by 260 independent dealers at 412 independent dealer locations and 17 company-owned retail centers.

Key Manager Statement

"We believe our profit in the second quarter is the result of our hard work over the last 2 years in reducing inventories, closing plants and sales centers, lowering labor costs, streamlining overhead, and improving our cost structure. We are keenly focused on producing the highest quality product and believe we are in a strong position to take advantage of opportunities as the industry recovers."

Wendell L. Batchelor, Chairman

Innotrac Corporation • INOC • Business Services

Atlanta, GA • IR Contact: Jennifer Sekel Church • 678-584-4055
www.innotrac.com



The strong momentum at Innotrac continues. The Company has exceeded consensus analyst earnings estimates four consecutive quarters and cash flows continue to be positive. Innotrac's solid balance sheet includes \$22.2 million in cash, no debt and an unused \$40 million credit facility. Net book value exceeds \$5.00 per share (over one third in cash) and gross margins surpassed 50% this year. Furthermore, Innotrac has enlarged its national presence through the acquisition of two fulfillment companies respectively operating in the West and Midwest corridors of the U.S. These fulfillment companies complement existing Southeast and Southwest facilities. Innotrac delivers marketing support, order fulfillment and call center services to clients including BellSouth, Qwest, Coca-Cola, Home Depot, and Nordstrom.com.

Key Manager Statement

"We are positioned to have an exceptional year at Innotrac as we enhance operations, enlarge our client base through acquisition and gain additional business from existing clients."

Scott Dorfman, President & CEO

SELECT Therapeutics, Inc. • XZL • Biopharmaceutical

Woburn, MA • IR Contact: Amy B. Tarbox • 781-935-8263
www.selecttherapeutics.com



SELECT Therapeutics, Inc., (AMEX: XZL), a development stage biopharmaceutical company, is pioneering the development of cell-based therapeutic products employing proprietary stem cells, tissue engineering, and cell targeting technologies. XZL's goal is to provide novel biopharmaceuticals that effectively treat and/or cure certain cancers, immunodeficiencies and infectious diseases.

Key Manager Statement

"Our technology engineers use stem cells to treat human diseases. For example, SELECT's flagship program utilizes its patented three dimensional scaffold, the patient's own stem cells and skin cells to create an artificial thymus, the organ responsible for producing T cells. The goal: to reconstitute a patient's immune system with healthy T cells to fight disease."

Steve Peltzman, CEO

FLEETBOSTON: BAIT?



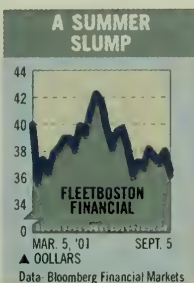
GENE G. MARCIAL

nt FleetBoston
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ck movements
tend a buyout

FleetBoston Financial (FBF), with assets of \$202 billion, has become the eighth-largest U.S. financial holding company and the dominant bank in New England—mainly through acquisitions. Now, there is buzz that it may be a target of Citigroup, HSBC Holdings, or Wells Fargo. FleetBoston was formed by the 1999 merger of Fleet Financial Group and BankBoston. Then in March, 2001, FleetBoston acquired New Jersey's leader, Summit Bancorp. Behind the acquisitions is CEO Terence Murray, who will step down at yearend, as prearranged, to make way for Charles Gifford, head of BankBoston, as the next CEO. Murray opposed selling FleetBoston, but Gifford, say some pros, could be more amenable.

FleetBoston has 1,200 branches in the Northeast and 150 in Latin America. Peter Gulli, of New York's Dalton, Greiner, Harman, Maher, says any bank that wants a foothold in the Northeast will find FleetBoston alluring. That would appeal to San Francisco's Wells Fargo. And FleetBoston's Latin presence could be formidable sources of growth for Citigroup. And HSBC is expanding worldwide.

FleetBoston fell from 42 a share in late May to 34 in mid-August. But in recent weeks, it has edged up to 37, partly reflecting accumulation by investors who see a buyout. "Traders betting on a deal have been buying heavily—shares and call options," says one trader. Gulli says that even without a deal, FleetBoston is an enticing value play—trading at a discount to its peers. The price-earnings ratio of 11, based on estimated 2001 earnings, is lower than the bank average of 16, says Gulli. FleetBoston declined comment.

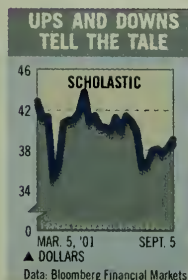


WIZARDRY AT SCHOLASTIC

Veteran technical analyst and market-timer Mark Leibovit usually doesn't buy and hold a stock—unless he sees something unusually compelling, such as an extended upswing.

That's what he says in is store at Scholastic (SCHL), the premier publisher of children's books and magazines.

Leibovit likes the way Scholastic has been behaving: For six months, it has traded in the 35 to 45 range. Recently it fell to 36, from which it has been rising, closing at 39 on Sept. 5. "The volume in these ups and downs tells the entire story," says Leibovit, who has developed a "volume-reversal" rule: When a stock comes down from a high level on un-



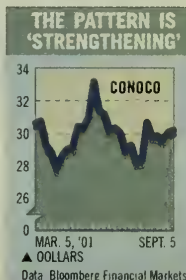
usually strong volume, it points to an imminent reversal in the stock's direction. That's the time to buy, he says. Scholastic has been falling from 45 on big volume, says Leibovit, who thinks the stock is bound to hit the mid-50s this year. "The shares are moving from weak hands to strong hands," he says—meaning that the stock is being bought by committed investors. The volume, he adds, means the recovery is real.

More fundamentally, Warner Bros.' release in November of a Harry Potter movie, based on the blockbuster series published by Scholastic, could precipitate strong buying in late October. If there's heavy volume, "more upside is likely," says Leibovit. Author J.K. Rowling has agreed to write a fifth Harry Potter book, to be put out by Britain's Bloomsbury Publishing, which owns the rights for English-speaking countries outside the U.S. Scholastic holds the American rights. Brandon Dobell of cs First Boston, who rates the stock a buy, expects Scholastic to earn \$2.40 a share in the year ending May 31, 2002, up from 2001's \$2.24.

WHY CONOCO MAY BE BUBBLING UP

The takeover pace in energy is fueling speculation about who'll be gobbled up next—after Santa Fe International's pact to buy Global Marine and after Devon Energy's deal for Anderson Exploration. To Andrew Addison of Addison Investment Management, who combines technical and fundamental analyses, Conoco (COC.B) is the No.1 choice. It's acting the way potential buyouts do: testing the highs and lows within a short span of six to 12 months. And, adds Addison, it has set higher lows from previous lows each time the stock falls from higher levels. From a low 25 in April, Conoco climbed to 33 in March, and then eased back to 27 in mid-July. It has since bounced back to 30. "The pattern says the stock is strengthening," says Addison, who doesn't own shares.

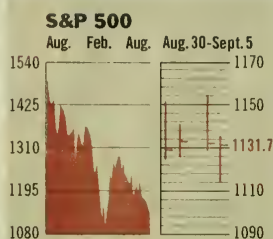
He sees Conoco hitting 35 before long, piercing an "upward resistance level" at 33. Conoco should then head for 55—unless a deal breaks through. Conoco's proved worldwide reserves of 2.64 billion barrels of oil and gas would increase by 40%, analysts say, once its acquisition of Gulf Canada is approved. Conoco, spun off by DuPont in 1999, should earn \$3.30 a share in 2001, up from last year's \$3.08, says Paul Ting of Salomon Smith Barney, who rates Conoco a buy.



BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:20 p.m. EST on CNNfn's *The Money Gang*.

Stocks



COMMENTARY

The equity markets essentially shrugged off a report of increased orders from the NAPM and a better-than-expected productivity number and continued their slump. Hit hardest was the Nasdaq, registering a 4.6% decline, followed by S&P 500 and the Dow Jones Industrials, down 1.5% and 0.6%, respectively. Volume, however, was light, suggesting that it's a buyers' market.

Data: Bloomberg Financial Markets
Bridge Information Systems, Inc.

U.S. MARKETS

	Sept. 5	Week	% change Year to date	Last 12 months
S&P 500	1131.7	-1.5	-14.3	-24.9
Dow Jones Industrials	10,033.3	-0.6	-7.0	-10.9
Nasdaq Composite	1759.0	-4.6	-28.8	-57.5
S&P MidCap 400	486.3	-2.1	-5.9	-10.2
S&P SmallCap 600	221.3	-1.8	0.8	-0.4
Wilshire 5000	10,472.6	-1.6	-14.0	-26.3

SECTORS

	Sept. 5	Week	% change Year to date	Last 12 months
BusinessWeek 50*	748.9	-2.5	-22.8	-42.1
BusinessWeek Info Tech 100**	362.1	-5.7	-36.0	-62.9
S&P/BARRA Growth	570.0	-1.0	-17.1	-36.8
S&P/BARRA Value	562.1	-1.9	-11.6	-11.0
S&P Energy	857.3	0.2	-8.0	-6.3
S&P Financials	144.2	-1.8	-12.4	-8.1
S&P REIT	94.7	-1.6	7.6	13.0
S&P Transportation	685.2	1.7	-1.8	13.9
S&P Utilities	277.4	-2.7	-20.9	-12.3
GSTI Internet	87.9	-5.0	-51.6	-81.8
PSE Technology	609.9	-5.3	-25.1	-47.0

*Mar. 19, 1999 = 1000 **Feb. 7, 2000 = 1000

GLOBAL MARKETS

	Sept. 5	Week	% change Year to date
S&P Euro Plus (U.S. Dollar)	1046.1	-6.6	-26.6
London (FT-SE 100)	5316.0	-1.9	-16.6
Paris (CAC 40)	4571.6	-5.4	-29.6
Frankfurt (DAX)	5048.1	-4.8	-25.6
Tokyo (NIKKEI 225)	10,598.8	-3.5	-21.6
Hong Kong (Hang Seng)	10,943.1	-2.7	-26.6
Toronto (TSE 300)	7447.7	-0.6	-15.6
Mexico City (IPC)	6088.5	-3.7	-17.6

FUNDAMENTALS

	Sept. 4	Wk. ago
S&P 500 Dividend Yield	1.37%	1.34%
S&P 500 P/E Ratio (Trailing 12 mos.)	31.3	32.0
S&P 500 P/E Ratio (Next 12 mos.)*	20.2	20.9
First Call Earnings Revision*	-2.4%	-2.56%

*First Call Corp.

TECHNICAL INDICATORS

	Sept. 4	Wk. ago
S&P 500 200-day average	1251.5	1256.2
Stocks above 200-day average	59.0%	62.0%
Options: Put/call ratio	0.88	0.70
Insiders: Vickers Sell/buy ratio	2.75	2.82

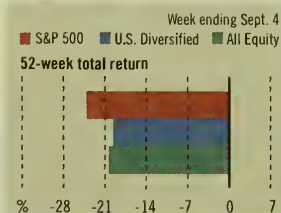
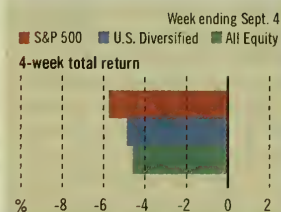
BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Metal & Glass Containers	14.5	Engineering & Constr. 101.8
Engineering & Constr.	14.1	Toys 70.8
Cosmetics	11.7	Pollution Control 68.2
Soft Drinks	10.5	Tobacco 61.7
Gold Mining	10.0	Hospital Management 53.9

WORST-PERFORMING GROUPS

	Last month %	Last 12 months %
Major Regional Banks	-26.2	Communications Equip. -26.2
Communications Equip.	-24.8	Computer Systems -24.8
Money Center Banks	-23.0	Semiconductors -23.0
Specialty Appar. Retailers	-21.0	Instrumentation -21.0
Personal Loans	-19.9	Oil & Gas Drilling -19.9

Mutual Funds



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-week total return	%	52-week total return	%
Leaders		Leaders	
Precious Metals	2.9	Real Estate	16.5
Health	1.3	Small-cap Value	12.9
Real Estate	1.0	Mid-cap Value	12.7
Small-cap Value	-1.1	Financial	9.3
Laggards		Laggards	
Technology	-15.3	Technology	-60.6
Communications	-13.1	Communications	-58.1
Japan	-9.3	Japan	-41.5
Large-cap Growth	-7.4	Mid-cap Growth	-38.2

EQUITY FUNDS

4-week total return	%	52-week total return	%
Leaders		Leaders	
ProFunds UltraShort OTC	37.0	Potomac Internet Short	244.9
Rydex Dynamic Vent. 100	36.8	Rydex Dynamic Vent. 100	189.4
Potomac Internet Short	32.0	ProFunds UltraShort OTC	180.1
Rydex Arktos Investor	18.0	Rydex Arktos Investor	111.2
Laggards		Laggards	
ProFunds UltraOTC Inv.	-30.8	ProFunds UltraOTC Inv.	-91.9
Berkshire Focus	-29.1	Potomac Internet Plus	-86.1
Berkshire Technology	-29.0	Berkshire Focus	-85.9
Potomac Internet Plus	-26.5	Berkshire Technology	-85.9

Interest Rates

KEY RATES

	Sept. 5	Week ago
MONEY MARKET FUNDS	3.32%	3.34%
90-DAY TREASURY BILLS	3.41	3.42
1-YEAR TREASURY BILLS	3.47	3.44
10-YEAR TREASURY NOTES	4.97	4.78
30-YEAR TREASURY BONDS	5.48	5.36
30-YEAR FIXED MORTGAGE†	6.89	6.82

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 31% federal tax rate.

	10-yr. bond
GENERAL OBLIGATIONS	4.09%
TAXABLE EQUIVALENT	5.93
INSURED REVENUE BONDS	4.25
TAXABLE EQUIVALENT	6.16

THE WEEK AHEAD

INSTALLMENT CREDIT Monday, Sept. 10, 3 p.m. EDT ► Consumers likely added \$4.2 billion of debt in July. That's according to the median forecast of economists surveyed by Standard & Poor's MMS, a division of The McGraw-Hill Companies. In June, debt fell by \$1.6 billion, the first decline since November, 1997, and the largest since April, 1992.

CURRENT-ACCOUNT DEFICIT Wednesday, Sept. 12, 10 a.m. EDT ► The U.S. current-account deficit likely narrowed in

the second quarter to \$105 billion, from \$109.6 billion in the first quarter.

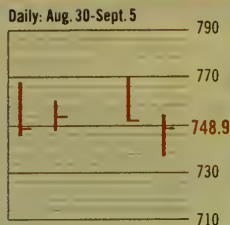
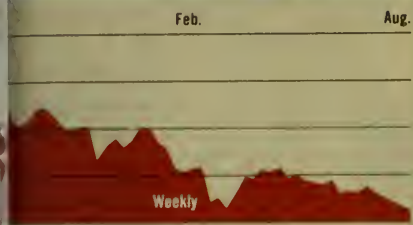
EXPORT-IMPORT PRICES Thursday, Sept. 13, 8:30 a.m. EDT ► Import prices in August are expected to have remained unchanged, while export prices are expected to have declined 0.2%.

PRODUCER PRICE INDEX Friday, Sept. 14, 8:30 a.m. EDT ► Producer prices of finished goods likely rose 0.1% in August, after slipping 0.9% in July. Excluding

food and energy, core prices likely rose 0.1%, as energy prices stabilized.

RETAIL SALES Friday, Sept. 14, 8:30 a.m. EDT ► Retail sales probably increased 0.3% in August. Excluding autos, probably grew at the same rate.

INDUSTRIAL PRODUCTION Friday, Sept. 14, 9:15 a.m. EDT ► Factory output likely rose 0.2% in August, and capacity utilization likely dropped to 76.6%. July output rose 0.1%, with a utilization rate of 76.6%.



fell 2.5%. Credit-card issuer Provident Financial sank 25.4% when it warned it would earn a few cents less than expected. It was followed closely by former tech stalwarts Sun Microsystems and Tellabs, down 17.6%, respectively. Bucking the trend were oil companies Exxon Mobil, up 2.1%, and Phillips 66, up 1.2%.

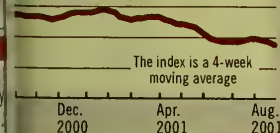
COMPANY PERFORMANCE

Company	% change		Rank	Company	% change	
	Week	Since 3/1/01			Week	Since 3/1/01
International	-4.5	-8.4	26	Verizon Communications	0.0	3.2
Exxon Mobil	-0.3	-16.5	27	Citigroup	-1.9	-6.3
Phillips 66	-9.3	-31.2	28	Sun Microsystems	-20.8	-47.0
Exxon Mobil	-4.0	-10.4	29	Merck	0.8	-15.1
Materials	-3.9	-7.2	30	El Paso	-1.2	-29.9
Financial	-25.4	-41.6	31	Altera	-0.1	10.4
Exxon Mobil	1.5	18.7	32	Marsh & McLennan	-1.3	-12.9
Exxon Mobil	-2.4	-20.6	33	Household International	-5.7	-2.0
Exxon Mobil	1.3	-6.7	34	Chevron	-0.4	5.3
Exxon Mobil	-9.6	-43.5	35	SBC Communications	1.9	-7.2
Brothers Holdings	0.0	-3.7	36	Mercury Interactive	-15.5	-58.5
Exxon Mobil	-10.9	-66.2	37	AOL Time Warner	-4.5	-16.5
Exxon Mobil	-13.7	-43.8	38	Washington Mutual	0.0	10.0
Laboratories	1.4	11.8	39	General Dynamics	-3.4	15.6
Exxon Mobil	0.9	-11.0	40	Comcast	0.1	-14.8
Exxon Mobil	-4.1	0.3	41	Morgan Stanley Dean Witter	-4.0	-18.7
Exxon Mobil	-0.3	-8.8	42	Tellabs	-17.6	-73.9
Exxon Mobil	0.0	7.9	43	Exxon Mobil	2.1	1.3
Exxon Mobil	0.4	-5.6	44	Scientific Atlanta	-8.2	-58.8
Exxon Mobil	-6.3	-63.9	45	U.S. Bancorp	0.0	3.9
Exxon Mobil	-7.4	-5.9	46	Paychex	-7.7	-11.2
Exxon Mobil	1.2	10.6	47	Merrill Lynch	-1.2	-14.5
Exxon Mobil	-9.0	7.7	48	Bed Bath & Beyond	1.1	14.8
Exxon Mobil	-1.4	-27.2	49	Texas Instruments	-1.8	3.2
Exxon Mobil	1.1	10.6	50	Teradyne	-9.7	-2.4

Production Index

Change from last week: -0.5%
Change from last year: -4.9%

INDUSTRIAL OUTPUT Aug. 25=167.5 1992=100



The index fell for the third consecutive week. The calculation of the four-week moving average edged up to 166.6, from 166.5. On a seasonal basis, rail-freight traffic was up on the day by gains in coal and auto production. Also higher, while electric power was virgined. Steel, truck assemblies, and crude oil all down. For all of August, the index declined 0.5, from 169.5 in July.

Each of the index components is at www.businessweek.com.
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Service management icons Karl Albrecht and Ron Zemke reveal time-proven strategies for restoring customer value to the center stage of business in *Service America in the New Economy*.

While retaining core concepts from the bestselling *Service America!*—including The 10 Eternal Truths of Service—Albrecht and Zemke's most recent book offers a critical analysis of why, when it comes to service, the new economy is stumbling. *Service America in the New Economy* provides strategies for winning and keeping customers by restoring the human touch to high tech.



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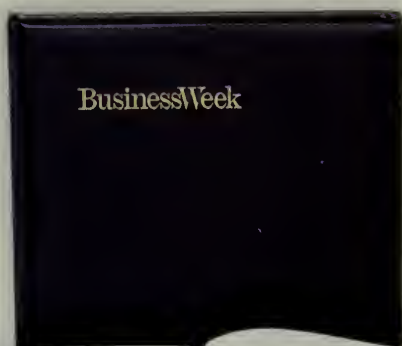
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JACK WELCH: A CEO WHO CAN'T BE CLONED

John F. Welch is taking his final bow on the corporate stage as he leaves General Electric Co. after 41 years, half of them as chairman and CEO. It is a testament to the success of the man that no other business manager anywhere rivals him in terms of peer respect. Welch's legacy will be much discussed and debated. Chief executives and business-school professors are already seeking to distill Welch's strategies so as to replicate them. Many are certainly transferable—being first or second in your market; the leveraging of services for industrial products; the key role that finance plays in a conglomerate. But in the end, Welch's success is likely to underscore the power of personality in changing organizations. And that will be very hard to transfer.

Demanding, intense, coarse, sarcastic, volatile, restless, Welch practiced a "tough love" kind of locker-room leadership that brought out the best in most but alienated many (page 82). The high school hockey captain from a working-class family in Salem, Mass., was able to mold GE's culture to reflect his own kind of in-your-face personality. This is rare in big institutions, which usually force individuals to conform to the existing culture. Welch used emotion far more than most managers to get results. He expressed anger often, and some employees were afraid of him. Yet Welch could also be very warm to close executives around him, lavishing them with handwritten notes and showing concern for personal family

matters. Welch turned GE into what he was most comfortable with—an aggressive, competitive male culture, with heavy penalties and rich rewards. Women especially found it an uncomfortable environment. It did work, however, in delivering on the bottom line year after year.

But Welch's way has serious limitations. In an increasingly multicultural, global world, GE's top managerial culture is too homogeneous, too male, and probably too American. While the middle ranks of the company are filled with Asians and Europeans, that's not so higher up. As with so many charismatic people, Welch's strengths turn out to be his weaknesses.

And he knows it. To his credit, Welch didn't try to convince himself in appointing a successor. He chose a very different personality, one who promises to improve GE's corporate culture in ways that Welch couldn't. Jeffrey R. Immelt is outspoken, Ivy League, and intent on building a multicultural cadre of GE executives (page 78).

There is no one corporate playbook that Welch is leaving behind, and Wall Street is beginning to take notice. GE stock is down 30% for the year. But what Welch leaves behind may be more lasting than the shrinking "Welch premium" for GE stock. His real legacy may be that at the right time, in the right place, one individual can make a huge difference. This is a valuable lesson transferable to all of society, not just the business community.

FREE TELECOM FROM MONOPOLY SHACKLES

People are returning from their summer vacations to face both good and bad news on the sluggish recovery. In those parts of the economy where competitive market forces are free to work, restructuring and consolidation are well along. In manufacturing, there are strong signs of a bottoming and a return to growth in the near future. In high tech, intense price competition is driving Hewlett-Packard Co. to acquire Compaq Computer Corp. in what is probably the first of a wave of deals to sweep the PC and server sectors. But in telecom, things are getting worse, not better. Monopoly markets and bad government policy are slowing consolidation. Regulators and legislators should examine the economic price America is paying for the telecom imbroglio.

Telecom was the driving force for economic growth in the '90s. Telecom investment grew 25% annually in the latter half of the decade. This year, it will be off 18%. Next year, it will be down 20% more. Capital budgets of the biggest telecom companies will fall to \$82 billion in 2002, from \$124 billion in 2000 (page 104). This startling decline threatens to weigh heavily on the recovery well into 2002.

It is easy to blame the general downturn for the decline in telecom capital spending. But telecom is shackled in large part because bad government policy has allowed the Baby Bells to

stifle competition. The Baby Bells no longer need to add capacity because they no longer have any rivals. The dozen telecom upstarts that tried in the '90s to compete with the Bells have filed for bankruptcy. Few ever made any profit. The Bells charged them high fees for access to local markets and even used the courts to block entry entirely.

The telecom upstarts prompted the Bells to upgrade broadband networks to businesses and consumers, and the billions spent helped spark the fast economic growth that brought millions prosperity in the '90s. That's all gone now. The maining telecom startups are, by and large, frozen in place, unable to restructure and consolidate. Meanwhile, the Bells, with cash flowing in through their local telephone monopolies, patiently wait for the challengers to starve to death.

The U.S. economy is working its way through this business cycle. The latest National Association of Purchasing Managers report showed significant increases in the indexes for new orders and production, both jumping to yearly highs. Market forces are already beginning to pull the economy ahead toward recovery. But monopoly forces threaten to delay that recovery and undermine its robustness. Regulators concerned with free markets and politicians worried about the next elections should take note.

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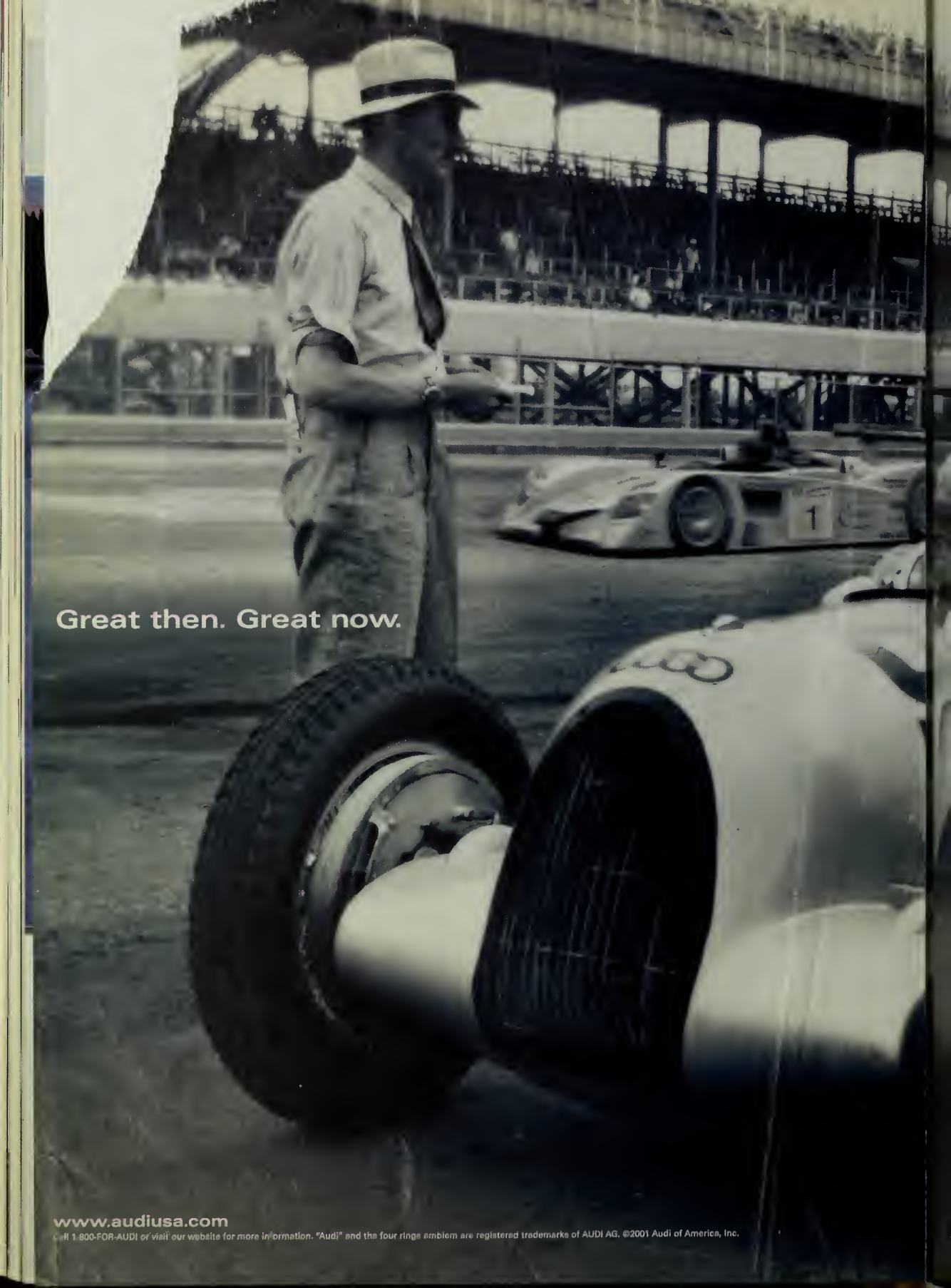


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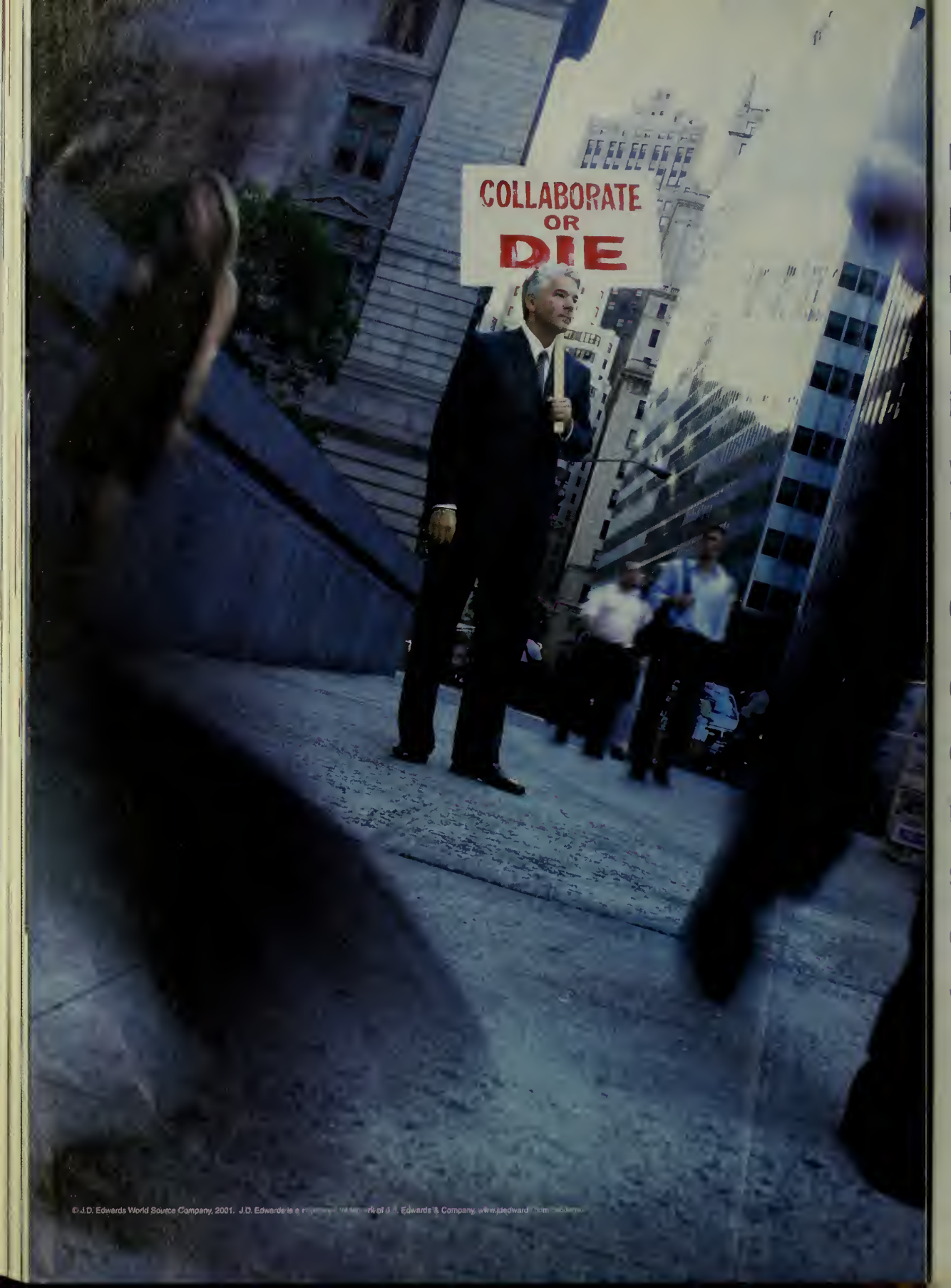


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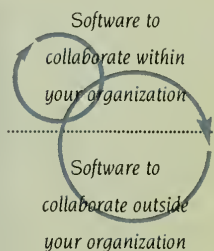


A man in a dark suit and tie stands on a city sidewalk, holding a white sign with red text. The sign reads "COLLABORATE OR DIE". He is looking towards the camera. In the background, there are tall city buildings and other people walking. The scene is captured from a low angle, making the buildings appear very tall and imposing. The lighting is bright, suggesting daytime.

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A black and white photograph of a snowy landscape. In the foreground, there is a fence made of wooden posts and wire. A dark, bare tree stands in the middle ground. The background is a hazy, snow-covered field under a cloudy sky.

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Up Front

EDITED BY SHERIDAN PRASSO

VITAL LINKS

THIS WAS WHY THE NET WAS CREATED

THE INTERNET, BORN 32 YEARS ago as a decentralized network designed to work in adversity, triumphed in the most severe emergency in U.S. his-



HEROES: *The Net pitched in*

tory. With Northeast phone and cellular lines clogged with twice the normal levels of traffic, companies and people found the Net the best way to communicate.

CAR TALK

A RUN ON RENTALS

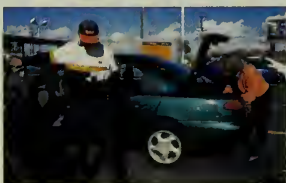
COMPLETE CHAOS. CAR RENTAL counters nationwide experienced it when, suddenly, the only way to get anywhere on Sept. 11 was by road. Rental offices and reservation lines were jammed, as travelers on more than 5,000 flights were required to land at the nearest airport, hundreds of miles from their destinations. The scene at the Eugene (Ore.) airport, where several West Coast corridor flights had to land, was typical: Long lines of stranded passengers snaked out the door as National Car Rental ran out of cars by 9 a.m. and was quickly followed by Avis,

Companies such as Coca-Cola e-mailed employees to go home. Motorola also sent e-mail updates, including how to make donations. Others, including Credit Suisse First Boston, posted updates for clients. AOL logged 1.2 billion Instant Messages, thought to be a record. Several Web sites created search tools to track survivors. In Seattle, 50 CIOs at a tech conference abandoned their geeky topics to go online. David Reed, who helped develop the Net as an MIT professor, received e-mail updates from New Yorkers. "It gave me a better picture of what was going on than what was on TV," says Reed.

Not every use was positive: News sites were jammed and postings to Sina.com in China said the U.S. "deserved" it. *Roger O. Crockett, with bureau reports*

Hertz, and the others. Chicago-area rentals were depleted by midday. "There are indeed a lot of folks who are stranded or who are nervous and trying to get out of the area," says a spokeswoman for ANC Rental, which owns National's and Alamo's 268,000 cars.

The biggest problem was matching cars with people, most of whom wanted one-



AIRPORT EXIT: *The only way*

way rentals out of airports. Those scheduled to return cars were unable to get there. Budget Rent a Car alerted customers that "due to the national crisis, availability can't be guaranteed" and waived additional one-way drop-off charges. National and Alamo did likewise. It will take weeks, if not longer, to sort it all out. *S.P.*

HARD HIT AT THE WORLD TRADE CENTER

The terrorist attacks on the World Trade Center devastated businesses both large and small. Companies such as Morgan Stanley, the largest WTC tenant, lost offices linked to larger operations elsewhere (page 46). But smaller companies headquartered there, such as investment bankers Keefe, Bruyette & Woods, had their entire operations obliterated. Here are the major former tenants:

1. MORGAN STANLEY

WTC's largest tenant, with 3,500 people employed in individual investor and asset management services in the WTC complex. CEO reported "most" were evacuated.

2. PORT AUTHORITY OF NEW YORK & NEW JERSEY

Occupied 859,000 sq. ft. of WTC space, with offices for 124 people.

3. AON RISK SERVICES

Chicago-based insurance conglomerate had 1,100 employees on high floors of South Tower.

4. EMPIRE BLUE CROSS & BLUE SHIELD

Headquarters of largest health insurer in New York; employed 1,914; 39 missing as of Sept. 12.

5. MARSH & MCLENNAN

Insurer and parent of Putnam Investments and Mercer Consulting; had accounted for only 1,000 of its 1,700 WTC staff by Sept. 12.

6. BANK OF AMERICA

WTC administrative offices employed 400; most escaped.

7. DEUTSCHE BANK

German financial services company, with U.S. headquarters in Midtown, had 350 in WTC complex.

8. OPPENHEIMER FUNDS

Mutual fund with more than \$125 billion in assets; occupied 261,000 sq. ft. of South Tower. All 600 employees accounted for.

9. GUY CARPENTER

Leading reinsurance intermediary owned by Marsh & McLennan, on eight floors of South Tower.

10. CREDIT SUISSE

Global investment bank; 800 employees evacuated from 5 World Trade Center, next to the towers.

11. KEEFE, BRUYETTE & WOODS

Institutional securities broker and investment bank; leased two floors at WTC with 175 employees.

12. CANTOR FITZGERALD

Largest government bond broker and trader of fixed-income securities on 4 floors at the top of the North Tower; half of 2,000 employees missing as of Sept. 12; had provided rent-free office space to a cystic fibrosis charity.

Data: Bloomberg Financial Markets Company Reports

AT THE TOP OF A TERRIBLE LIST

The destruction of the World Trade Center will be the most costly man-made disaster in U.S. history. Damage from 1992's Hurricane Andrew reached \$18.4 billion,* and losses from the WTC attack will be comparable.

INSURED LOSSES FROM THE FOLLOWING MAN-MADE DISASTERS

1. WORLD TRADE CENTER TERRORIST ATTACK	\$10 billion to \$30 billion**
2. THE GREAT CHICAGO FIRE, 1871	\$2.3 billion
3. LOS ANGELES RIOTS, 1992	\$775 million
4. WORLD TRADE CENTER BOMBING, 1993	\$510 million
5. OKLAHOMA CITY BOMBING, 1995	\$125 million

*Adjusted for inflation **BW est. Data: Insurance Information Institute

TALK SHOW "This is the demarcation point between what was—the Roaring '90s—and whatever now is."—Bank One CEO James Dim



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YOU'RE LOOKING AHEAD TO SEE WHAT'S NEXT.

THIS IS LEADING.



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SAVORING THE FINE POINTS OF THE WINE BUSINESS

"Wine war" (Cover Story, Sept. 3) laments the restrictive aspects of French law—the *appellation contrôlée* system—by noting that adding "oak chips" to fermenting wine is prohibited. As any self-respecting Napa Valley or Barossa Valley (Australia) vintner will attest, using oak chips for flavor instead of barrel-aging is a dubious shortcut resulting in mediocre wine. French rules, in force since 1935, served to improve their product to the point of dominating the world market, which they still do.

Fred Pieretti
 Madison, N.J.

I read "Wine war" with interest, having just washed down mussels with Spanish (Galician) white wine, a day after putting away pasta with Chianti Classico, one day after going to a terrific Provençal restaurant where we enjoyed white Burgundy. I am amazed to find no mention of Italy or Spain in the article about the trials and tribulations of the French wine industry. And how about the Germans and other European Union winemakers?

Edward Walworth
 Lewiston, Me.

New World marketers say French labels are confusing. It is precisely about origin that French labels are not confusing. More and more, estate-bottled California labels indicate the variety, the region, and the vineyard.

Hey, it's a pleasure to be "confused" by the differences between Zinfandel from Shenandoah Valley of California

and Dry Creek Valley. With origin being, I don't have to be a connoisseur to make these distinctions: I can become one. The marketing of brand varietals just makes it easy for me to keep on being a "beer bum."

Robert W. Mayber
 Grand Haven, Mi

Worldwide business may justify being the last objective of our French wineries. Keeping alive a family tradition and cultivating a deeply rooted *terroir* may well be as noble a task as making millions out of the sacred grape. Dominique Feney
 Hous



France is the land of the paradox. You buy a half-cent bottle of wine, go buy for a second sometime later and it's nowhere near good. I have lived in France for 10 years, and have given up trying to buy decent wine at a decent price. I only wish I could find even a moderate selection of New World wines on Carrefour shelves. Howard Hux
 Pevy, France

"Wine war" should have focused more on wine culture, especially when stores in the U.S. get more of their revenues from wines preserved in plastic gallons. The topic of wine was good one for the summer, but the article tasted "corked."

Pascal Soar
 Kenmore, N.

Perhaps France will simply become a niche market for wines. So be it. There is always room for them on the world

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Although the forecast was accurate,
Bill wasn't one to express his feelings
for the NASA/NOAA GOES Satellite Imager.

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CORRECTIONS & CLARIFICATIONS

"Sara Lee: Changing the recipe—again" (The Corporation, Sept. 10), the name of Prudential Securities Inc. analyst John M. McMillin was misspelled.

age, and their quality and sophistication will continue to be at the forefront of winemaking.

Thomas Sommerfield
Auburn Hills, Mich.

If "savvy New World marketers" start using aluminum screw caps (with fer-proof and easy-open/reseal features), I believe they would increase their lead over the French growers. Or, the French went to this type of closure vs. hard-to-open and difficult corks, they might regain some of the market.

Jerome Bonat
Fort Lee, N.J.

THE BUICK RENDEZVOUS: GATHERING SPEED

I feel compelled to respond to your inclusion about the success of our all-new Buick Rendezvous ("Can Lutz help GM out of its slide?" (News: Analysis & Commentary, Aug. 20-27).

We are in the beginning stages of the Rendezvous launch. Our first full month of sales was May, and our advertising began to air in late June. Buick dealers are just now achieving retail inventory. Given that, Rendezvous still outsold the Acura MDX by over 300 units in July. Additionally, sales of all premium crossover vehicles except Rendezvous and the BMW X5 declined last month. We expect to achieve excess of 35,000 sales this year and 60,000-60,000 sales annually thereafter. Equally important, Rendezvous is demonstrating success in attracting new customers to our dealers' showrooms. Let's hold off making a decision about Rendezvous' success until [our] efforts have been tested in the market and results are in to back up the conclusion.

Roger W. Adams
General Manager
Buick Motor Div.
General Motors Corp.
Detroit

SETTING THE RECORD STRAIGHT THE ROYAL BANK OF SCOTLAND

"All that glitters" (International Business, Aug. 13) seriously misrepresents the record of the Royal Bank of Scot-

land Group PLC and its subsidiary, Citizens Financial Corp.

The story mentions the Group's recent agreement to acquire the retail bank franchise of Mellon Financial Corp. and then states: "You have to have an American presence, the thinking goes. The trouble is, you also have to make a profit."

The acquisition of Citizens and its subsequent growth in a series of acquisitions is by far the most successful in the U.S. of any British bank. Royal Bank of Scotland was the only British banking group to be consistently successful with its U.S. acquisitions, and its U.S. subsidiary was the only one to have remained profitable during the previous U.S. recession.

Howard Moody
Group Director, Communications
Royal Bank of Scotland Group
Edinburgh

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BY STEPHEN H. WILDSTROM

tech&you@businessweek.com

FINALLY, FLAT IS BETTER



Flat-panel PC screens are cheaper, brighter, and crisper than ever. So it's bye-bye, CRTs

For the past couple of years, I have been a lukewarm fan of flat-panel displays for desktop computers. Yes, they looked cool, saved space, and were a lot easier to move around than a bulky, heavy cathode-ray tube (CRT). But the image quality was usually not as good as a top-flight CRT, and the flat panels cost twice as much for the same display size.

My reservations are dissipating. A long period of steady-to-rising prices came to an abrupt end late last year, when a lot of new manufacturing capacity came available just as demand was softening. You can now buy a decent 15-in. flat panel, which has a usable viewing area not much smaller than a typical 17-in. CRT, for less than \$500. That's a drop of about 50% in the past year and only \$100 more than a first-rate CRT such as a Sony Multiscan 220s. The quality of liquid-crystal display (LCD) panels has been improving for some time, especially the capacity to let you see a clear, bright screen from various angles. And a largely unpublicized feature of Microsoft's forthcoming Windows XP operating system makes possible a dramatic improvement in the appearance and legibility of text on LCDs.

FIXED PIXELS. When considering a flat-panel display, you have to be aware of some differences between LCD and CRT technology. The most important one is that pixels, the little dots that make up the picture, are permanent rectangular areas on an LCD screen; you can't adjust their size. (CRTs, on the other hand, let you specify how large you want the pixels to be.) As a result, a flat-panel works well at only one resolution setting, while a CRT gives you choice. If you are willing to trade less information—fewer lines of text in a window, for instance—for larger type, you can set a CRT at 1,024-by-768 pixels, for example, instead of 1,280-by-1,024. Since flat-panels lack this flexibility, it's up to you to make sure that the resolution is comfortable before you buy the monitor.

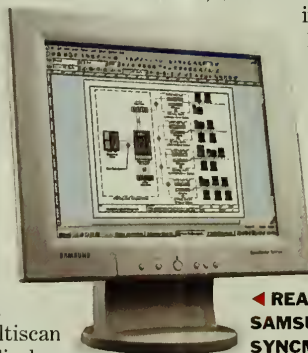
A second issue is digital vs. analog displays.

Digital displays can offer better image quality and may be a bit cheaper, but they will work only if your computer has a digital display (DVI) connector. Most don't, which is why most displays are either analog or dual-mode. Desktop Macintoshes have digital connectors, but they work only with Apple displays.

EXTRA BELLS. Flat-panel displays carry a wide range of prices. You can pay \$400 to \$900 for a 15-in. model or \$750 to \$1,200 for a 17-incher. To some extent, you get what you pay for. More expensive models tend to have brighter, higher-contrast screens, better antiglare coatings, wider viewing angles, and more attractive designs. But you could end up paying for features you'll never use, such as the ability for computers to share a screen, inputs for TV-type video signals, or color controls intended for graphics professionals.

I tried two relatively inexpensive models, a 15-in., \$790 Samsung SyncMaster 760TFT and an 18-in., \$1,000 NEC Mitsubishi Multisync 1830. Both are analog units and gave excellent image quality when tried on a variety of Windows and Mac systems. Both ran at 1,280-by-1,024 pixels, so the NEC showed slightly larger images, which might make it a good choice if your close vision isn't what it used to be. When you shop, decide what features you

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SYNCMASTER
760TFT



◀ **SHARPER IMAGE:**
NEC'S 18-INCH
MITSUBISHI
MULTISYNC 1830



need—for example, whether you want built-in speakers or USB ports—then trust your eyes. If it looks good, it is good. Make sure, though, that you can return a monitor you buy. Some flat panels just don't look sharp without some display adapters, and you can't be sure until you try them.

All LCD displays will look a lot better when running Microsoft Windows XP. The new system includes a technology called ClearType, originally developed for electronic-book readers, that provides a dramatic improvement

in the appearance of type on flat-panel displays. ClearType smooths the often jagged appearance

of text. The gain in legibility is most marked at small sizes—especially in italic type, which can be very hard to read on the screen. Although serif type may still appear a bit fuzzy, the overall effect is a big plus. Windows XP and 2000 also let you make some, but unfortunately not all, trade-offs on high-resolution flat-panel displays.

The combination of better display software and a continuing decline in prices is likely to increase the popularity of flat panels and, of course, laptops. The venerable CRT has served us well, but its days may be numbered.

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JACK
Straight from the Gut
 by Jack Welch with John A. Byrne
 Warner Business Books • 479pp • \$29.95

JACK WELCH: THE LION ROARS

(KEN AULETTA)

Being in a room with Jack Welch is like being cornered by an alluring yet dangerous lion. He does not tamely sit and await questions. He comes at a reporter the way he comes at his General Electric Co. employees: directly, impatiently, instinctually, alternately grinning or growling. Ask a question, and he is on you—challenging your assumptions, craving for information, his voice rising in a shout or dropping to a purr, his lithe feet propelling him around the room as he circles you. He is one part charming, electric, shrewd, an engrossing teller of stories, a gossip—and one part beast.

Welch's memoir, *Jack: Straight from the Gut*, has the virtue of placing rangers in that room, offering them a sense of this man who may be the most influential CEO of the second half of the 20th century. "Write like you talk" is the best advice for any writer, particularly if you're a reasonably good talker. Welch is, and the voice that he and *BusinessWeek* Senior Writer John A. Byrne provide is the same one heard by visitors to his office. We hear here and there the familiar success stories—how he downsized GE, excising "one out of every four people" in his first five years at the helm; of profits that mushroomed from \$1.5 billion in 1980, the year before he became CEO, to \$12.7 billion in 2000; of a share price that rose an average of 21% in each of the past 10 years—50% faster than the Standard & Poor's 500-stock index; of how he gave an identity on Wall Street to his sprawling company by insisting on achieving ever-expanding quarterly-profit growth and shedding divisions that did not rank No.1 or No.2 in their businesses; of how his ideas about globalization and a boundaryless company and

cost-cutting in good times and by-the-numbers managing spread to other companies like an infectious disease.

If Welch's book were just a roar, or just flashed his medals, he would have produced a self-reverential tome not unlike Sumner B. Redstone's or Michael D. Eisner's. But this is a much better book than those. Despite its good qualities, though, it has some problems, the biggest being a confusion over who the audience is, the reader or his GE compatriots. Welch regularly pauses to offer testimonials to this board member or that lawyer or vice-president. It becomes tedious. This confusion between honestly trying to tell his story with humor and humility and trying to thank or protect his teammates sometimes cheats the reader. For example, in his interesting account of the shrewd way he went about picking a successor, Welch does not tell us why he chose Jeffrey R. Immelt over two competitors, or what he perceived as the others' relative weaknesses. This spares their feelings but fails the reader.

Most of the time, however, Welch illuminates what he did as CEO. Because he saw the CEO's role as that of a teacher, not just a decider, and because he seeks to use this memoir to instruct, the reader also learns some lessons. The first, which is only implicit in the book, is to beware of the shibboleths of those who sell the latest how-to business fads. After the collapse of sprawling giants such as ITT, we were told that conglomerates don't work, that companies had to be focused on core businesses and "stick to their knitting." Welch successfully defied these injunctions. Ditto the notion that size is the enemy of speed.

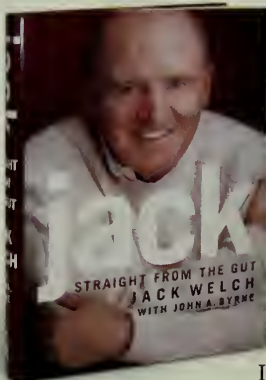
Ditto the idea that a CEO must not meddle or micromanage and instead must step back and delegate.

A larger lesson is explicit and personal and traces back to the lion—or maybe the lioness. The first chapter begins with an anecdote about Welch's mother. Grace Welch pushed her only child to excel in school and everywhere else. She came to his Salem (Mass.) High School hockey games, including one lost in overtime, when Jack got so mad he flung his stick across the rink. Back in the locker room, the door flung open and in barged tiny Grace Welch. She grabbed the top of Jack's uniform and in front of his teammates yelled: "You punk! If you don't know how to lose, you'll never know how to win." She was, he writes, "the most influential person in my life. Many 'of my basic management beliefs—things like competing hard to win, facing reality, motivating people by alternately hugging

and kicking them, setting stretch goals, and relentlessly following up on people to make sure things get done—can be traced to her as well.... Perhaps the greatest single gift she gave me was self-confidence. It's what I've looked for and tried to build in every executive who has ever worked for me. Confidence gives you courage and extends your reach.

It lets you take greater risks.... My mother never managed people, but she knew all about building self-esteem."

No, Jack Welch is not a psychobabbler. The more than 100,000 employees he downsized can testify that he is not a touchy-feely kind of guy. But the core lesson of this book is that human qualities and the "soft stuff" of management—pride that stops short of hubris, the humility to listen, a team corporate culture, creating "the informality of a neighborhood corner grocery store in the soul of a big company," focusing on people development—matter more than astringent business plans. "Great people, not great strategies, are what made it all work," writes Welch. Near the end of the book, he tries to sum up what made him a successful



WELCH'S CANDOR DOESN'T EXTEND TO SUCH KEY ISSUES AS HIS CHOOSING IMMELT TO SUCCEED HIM

CEO. By my count, 18 of the 30 qualities he cites—including “setting a tone” or making employees “feel my presence,” “informality,” “passion,” “self-confidence,” “integrity,” “stretch,” “culture counts,” “mingling” with the troops, and creating a feeling of working for a non-hierarchical organization—cannot be reduced to a how-to formula.

Even before the Web, Jack Welch was interactive. A natural gossip, he knew thousands of employees by their first names and was hungry to learn as much as he could about his executives. He reshaped GE’s 52-acre Crotonville (N.Y.) training center into a reeducation camp and pulpit to disseminate his views. But that campus was also a place he used to size up executives, to see if they pushed back, had passion, would stretch. He prowled in front of a lectern, never giving a formal speech, always trying to undress people with probing questions. As he tried to do with reporters, he was always fishing for information. Every executive who performed at an A or B level had to spend time at what he calls “the Crotonville pit,” where each, in writing and in person, had to identify and discuss his or her (at GE they were mostly his) potential successors. Each also had to travel to Fairfield, Conn., or Boca Raton, Fla., or elsewhere to attend a stupefying number of corporate executive councils, session C reviews, session I reviews, session II reviews, and work-out sessions.

True, Welch was lucky. He had the good fortune of a strong economy at his back for most of his 20 years. And he did make his share of mistakes. In

retrospect, his impatience earlier this year to close a purchase of Honeywell International Inc. blinded him to the opposition that would build among European regulators. Similarly, his worries about drugs, payola, and other perils of the music industry prompted him to sell RCA Records too quickly and cheaply. He acquired NBC, and under Robert C. Wright, it has thrived. But because Welch refused to dilute GE stock with expensive purchases, NBC is the

has been a pioneer in pushing NBC’s skill for its various products. He boasts in this book of placing calls to NBC News to get *Today* to invite the anchors of its sister, *Business Center*, CNBC, to help boost its ratings against CNN’s *Moneyline*. He describes goading CNBC to cover business news as “game” or “sport,” seeming not to realize that he bears some responsibility for the hyperventilated reporting that contributed to the dot-com bubble.

His MSNBC appearances are often reports to the news as a spot of sorts—much like wrestling. He describes the *New York Post*—not the *Wall Street Journal* or the *New York Times*—as “my favorite paper.”

He dismisses government environmental complaints that GE has polluted the Hudson River with PCBs. He writes: “Good science and common sense have become drowned out by loud voices.”

PUBLIC AND PRIVATE

Welch slamming a point across; relaxing with two of his grandchildren; and in 1981, shortly after being appointed chairman of General Electric

es and extreme views” held by those who seek “to challenge the basic role of the corporation.” This ignores some convenient facts: Republican Governor George E. Pataki and most of the state congressional delegation have attacked GE. Those well-known “extremists” the Bush Administration have sustained the Clinton Administration’s order for GE to spend \$500 million to dredge a 40-mile stretch of the Hudson. Welch justifiably observes that this dredging a massive and expensive undertaking that will perhaps wreak more environmental damage than leaving the river to rest. But then he offers: “We’ll spend whatever it takes to do the job right. If PCBs are not a problem, why make such an offer?”

At one point, Welch boasts of a conversation with a manager of a Fifth A



alone network without a studio to supply it with product. And NBC now competes against such vertically integrated behemoths as AOL Time Warner, Viacom, and Vivendi. He handles with humor his own hubris in believing that GE could find synergies by buying Kidder, Peabody. “The talent goes up and down the elevators every day and can go in a heartbeat. All you’re buying is the furniture,” warned company director Walter Wriston.

Welch has been justly celebrated as a business lion—and the book reveals a certain beastliness. In the name of synergy and a boundaryless company, he

nue clothing store. Appearing the previous evening on *The Charlie Rose Show*, Welch had said it was "important for organizations to continually remove the bottom 10% of their employees." The store manager, who had seen the program, explained to the GE chief that he had a staff of only 20. "Mr. Welch, do I really have to let two go?"

"You probably do if you want the best sales staff on Fifth Avenue," answered Welch.

As a consumer, I, too, want the benefit of dealing with the best sales staff. But if my salesperson is graded a C, not a B—Welch forced executives to get rid of employees graded C performers—maybe that salesperson just needs some good management coaxing to improve. Or maybe other factors, including good community relations or building long-term loyalty, should come into consideration.

What if every company said it couldn't hire C performers? Welch describes the willingness to behead the boss as "a willingness to take the heat when you make the tough calls." It could also be described as callous or ruthless, or as a preoccupation with achieving a profit margin of, say, 19%, rather than taking into account other values, such as decency.

Corporations, as Welch says several times, are composed of human beings who do not wake up each morning thinking: How can I pollute more rivers or harm more consumers? But the pressure in corporations to achieve the financial goals set at the top by CEOs such as Welch sometimes compel their minions to go after TV ratings by broadcasting reality shows that feature contestants willing to let rats crawl over them, or lead the NBC-owned local TV stations to dumb down their news coverage, or spur executives to show their boss how tough they are by firing more people.

Whatever its philosophical or other flaws, this is a valuable, pungently written business book by a man who lights up every room he enters. This memoir served as a necessary bridge for Welch, allowing him to get free of his beloved GE. "It kept me out of Jeff's hair during most of the transition," writes Welch. He succeeds in making readers "feel my presence," as he said he wanted his employees to. In the end, you remember the alluring lion.

Auletta's most recent book is *World War 3.0: Microsoft and Its Enemies*. He writes the "Annals of Communication" column for *The New Yorker*.



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BY LAURA D'ANDREA TYSON

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BACKLASH
Democrats are right to blame Bush for budget woes, but withholding access to the Social Security surplus may further weaken the economy

Laura D'Andrea Tyson is dean of the Haas School of Business at the University of California at Berkeley.

President Bush finds himself in serious budgetary trouble. During the campaign, he solemnly promised that Social Security taxes would be spent on only one thing—Social Security. Now, even with optimistic economic forecasts and accounting gimmicks, recent budget projections show that he will have to tap the Social Security surplus to fund other programs throughout most of his first term. That's true even if popular tax breaks, such as the research-and-development tax credit, that are scheduled to expire are not renewed and even if not a penny is spent on developing a missile-defense system.

The Democrats, especially the majority who wisely voted against the President's tax plan, are understandably delighted at the prospect of attacking him for breaking his "read-my-lips" promise on Social Security in order to pay for tax breaks for the rich. Since Bush's multibillion-dollar tax package is responsible for the lion's share of the deterioration in the budget outlook over the next decade and is indeed strongly biased toward the wealthiest Americans, such attacks are as justifiable as they are politically enticing. Moreover, they are likely to resonate with voters, most of whom continue to rank Social Security above tax cuts in the nation's priorities. But what makes for an irresistible and timely political message contains some pitfalls that could come back to haunt the Democrats if the economy remains weak.

It is certainly true that both Social Security and Medicare face large unfunded liabilities when the baby-boom population begins to retire in about 10 years. It is equally true that using temporary Social Security surpluses to reduce the government's outstanding debt will make it easier to cover these liabilities as they become due. But it also is true that running a large federal surplus, whether on or off the Social Security budget, reduces aggregate demand and slows economic growth in the short run.

That's good economics when private investment and consumption are strong and the economy is booming. But it is flawed economics when the economy is faltering, as it is now. President Bush's economists—currently posing as converts to Keynesian economic logic—are right when they argue that this year's tax rebate is helping the economy, albeit modestly. A larger tax rebate would have been even better. But the Administration does not deserve the credit for sound fiscal policy. The rebate, which amounts to less than 2% of the total tax bill passed this year, was a Democratic initiative reluctantly accepted by

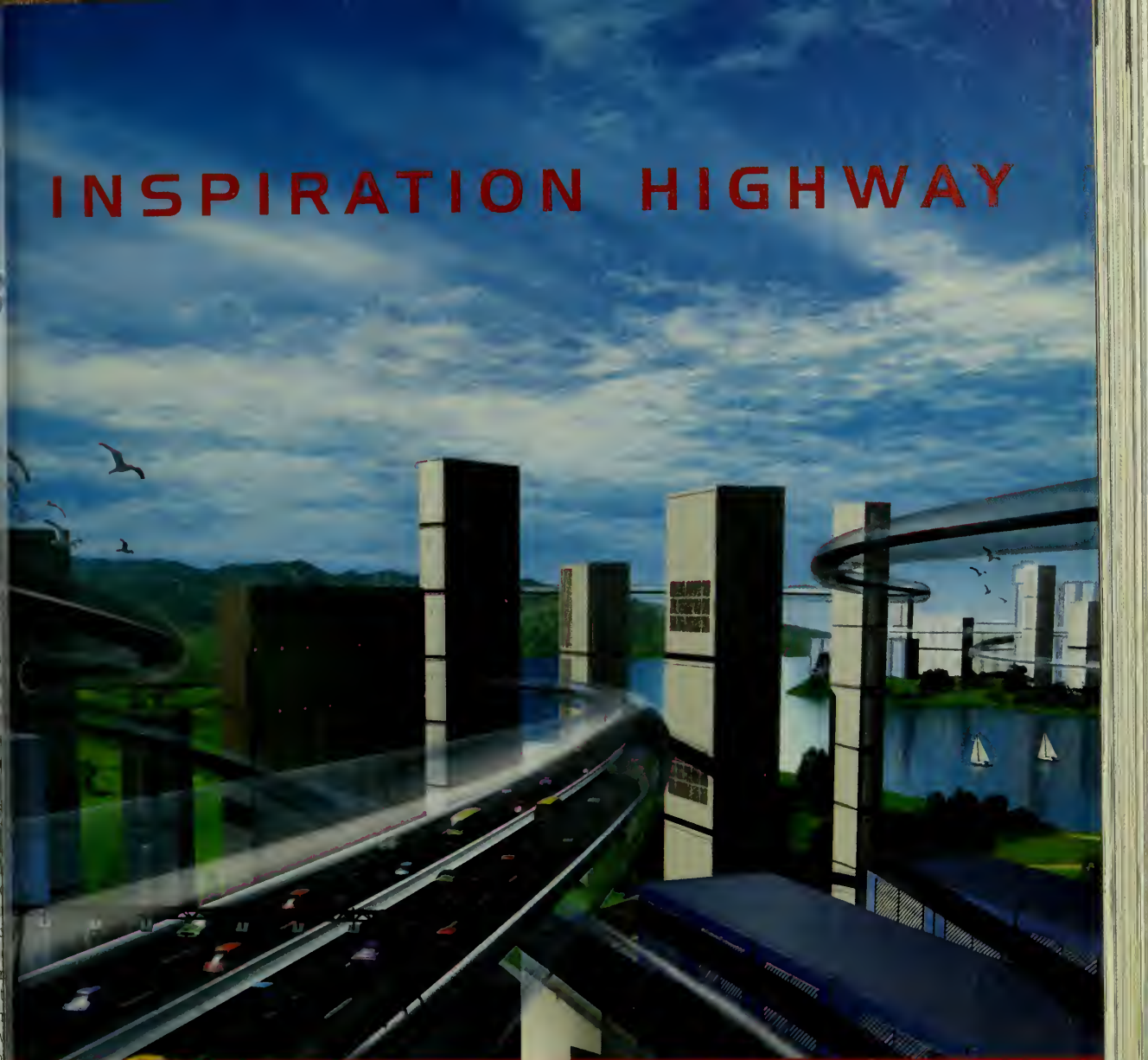
President Bush to win passage of his tax cut. Beyond this year's one-time rebate check, most Americans won't enjoy an additional time of tax relief from Bush's tax package. Moreover, the bulk of Bush's cuts, with an estimated price tag of over \$2 trillion, will not take effect until after 2004, by which time the economy will have recovered, according to most economic forecasters. In fact, by worsening the long-term budgetary outlook, Bush's tax plan is keeping long-term interest rates stubbornly high and acting as a drag on growth.

Contrary to what Larry Lindsey, Bush's chief economic adviser argues, this is actually a fortuitous moment to repeal Bush's future tax cuts, especially the reduction in the top income-tax rate and the elimination of the estate tax that will benefit only the wealthiest 2% of taxpayers. Some of the savings from the repeal should then be used to fund a cut in payroll taxes for some kind of investment tax credit next year.

UNPREDICTABLE. It is also an ideal time to establish some kind of conditional budgetary mechanism that both addresses the long-term liabilities of Social Security and Medicare and responds to short-term changes in macroeconomic conditions. The economy's sudden about-face serves as a dramatic reminder that such changes can be both large and unpredictable, rendering budget projections obsolete before the ink in which they are written has begun to dry. Given the inherent uncertainty in economic and budgetary forecasts, Federal Reserve Chairman Alan Greenspan warned earlier this year that any long-term tax cut should be phased in and conditioned on the realization of long-term targets for the federal debt and in covering Social Security's liabilities. His warnings went unheeded.

Developing credible budgetary rules will not be easy. The aim: to achieve long-range targets for reducing the government's debt and funding its future liabilities, while simultaneously adjusting the timing of changes in spending and taxes to reflect actual macroeconomic conditions. It's time to try. In the absence of such rules, the nation's political leaders will continue to engage in annual budget battles that produce misguided policy outcomes and that confuse and alienate America's voters. Unfortunately, it looks as if the next annual budget spectacle—filled with misleading economic analysis and rancorous counter-charges—is about to begin. Let's hope the final outcome doesn't further weaken the American economy.

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A close-up, low-angle shot of a woman driving a car. She is looking upwards with a slight smile, her face partially in shadow. The background shows the interior of the car, including the steering wheel and dashboard.

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BY GENE KORETZ

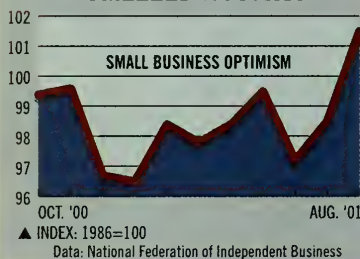
SMALL BIZ SAW A GLASS HALF FULL

In August, owners' spirits rose

Before the terrorist attack on America clouded the future, at least one bellwether business sector was beginning to see a ray of sunshine.

Economist William C. Dunkelberg of the National Federation of Independent Business reports that its small-business optimism index, drawn

SMALL BUSINESS OWNERS SMELLED A PICKUP



from its monthly survey of members, jumped three points in August, to 101.5—its highest level in a year. Ordinarily, he says, such a strong move suggests that economic growth is about to accelerate.

Especially encouraging was the surge in those expecting the economy to strengthen within six months. Optimists now outstripped pessimists by 25 percentage points, the highest reading since 1992.

Since small business has accounted for much of the nation's employment growth, its hiring plans say a lot about the labor market outlook. And these perked up appreciably in August—with a net 18% of owners planning to boost payrolls in coming months.

Further, the share of respondents reporting hard-to-fill openings jumped to 30% from 25% in July, and a historically high 17% of owners still indicated that finding qualified workers was their No. 1 business problem.

The sales and earnings pictures also brightened. In recent months, reports of sales declines significantly outnumbered gains, but in August, the ranks of gainers and losers were roughly equal. As a result, "the profit picture improved substantially," says Dunkelberg. At the same time, the net share

of owners expecting higher sales in coming months climbed to 18%.

Meanwhile, labor cost worries seemed to be abating a bit. Some 30% of small businesses raised compensation in recent months, but only 15% planned to do so in the coming months. Reflecting weak pricing power, relatively few owners have raised prices recently or were planning to do so.

In spite of their rising spirits, small concerns were playing it close to the chest last month. Many still saw their inventories as too high. And though there were signs that inventory liquidation was ending, few owners appeared interested in building stocks or boosting depressed capital spending.

Last month, small businesses felt the economy was poised to start growing again, says Dunkelberg, but were waiting for more evidence.

A TEENAGE SMOKING PUZZLE

Why did it surge in the '90s?

From 1991 to 1997, after a steady 15-year decline, the teenage smoking rate in the U.S. unexpectedly rose by a third, to some 35% of all youths. In two recent studies, Jonathan Gruber and Jonathan Zinman of Massachusetts Institute of Technology try to unravel the causes of this jump.

Their research turns up some surprises. Smoking rose more among whites than blacks, they find, more in the suburbs than the cities, and more among teens with high grades and college-educated mothers. Thus, while adult smoking is strongly associated with lower socioeconomic status, that proved less true of teenage smoking.

Despite these surprising trends, the two economists find that they explain less than 10% of the overall rise in youth smoking, which occurred in all groups. A more likely cause is a sharp drop in cigarette prices sparked by a tobacco-industry price war in the early 1990s. But even this development, the authors report, can explain only 26% of the subsequent rise in smoking by high school seniors—and little of the smoking surge among younger teens, who are far less price-sensitive.

Although a large part of the puzzle remains unsolved, the good news is that youth smoking has begun falling again in the wake of dramatic cigarette price increases in recent years. The authors warn, however, that teen

smoking is highly correlated with later adult smoking. Thus, they estimate that as much as half of the rise in youth smoking in the '90s may persist into adulthood, shortening the lives of more than a half-million people.

HOW WELFARE TO WORK WORKED

New analysis provides the numbers

When Congress enacted welfare reforms in 1994, many critics saw them as draconian efforts to cut welfare rolls. The inevitable results, they predicted, would be high chronic unemployment for single mothers forced to seek work, low wages for those who found it, and stunted pay gains for the overall low-wage workforce.

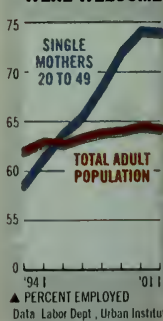
As a new Urban Institute analysis demonstrates, however, none of these dire predictions came true. Between early 1994 and the first quarter of this year, reports economist Robert I. Lerman, as the employment ratio of a working-age Americans rose by less than three percentage points, the share of single moms with jobs soared from 59% to 74%—reducing joblessness for this group from 13% to less than 8%.

Even more surprising, these employment gains were matched by healthy pay increases. Over the seven-year period, Lerman calculates that the real (inflation-adjusted) median wage of single working mothers rose by nearly 14%, to \$10 an hour.

To put this in perspective, although 15% of employed single mothers in 2001 were earning nothing five years ago, by early this year, the average working single mom took home 78% as much as the average worker. Meanwhile, other low-wage workers saw similar percentage increases.

Welfare reform worked so well in part because it occurred during an economic boom. The burning question today, however, is how much the skills and experience acquired by working moms will shield them from unemployment now that the economy has hit the skids.

SINGLE MOMS WERE WELCOME





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- ▶ Are your children able to articulate their strengths?
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BY JAMES C. COOPER & KATHLEEN MADIGAN

A RECESSION MAY BE INEVITABLE

The Sept. 11 attack will likely freeze consumer and business spending

U.S. ECONOMY

There's no escaping the conclusion: The surprise attack on the U.S. on Sept. 11 almost surely pushed this fragile economy into a recession.

Consumer confidence is undoubtedly plunging as Americans struggle with the once unimaginable idea of a large-scale terrorist attack on U.S. soil (table). The near-term implications for U.S. financial markets remain uncertain, and investors around the world are stunned. With the political repercussions not fully played out, the extent of the economic damage may not be known for months.

Forecasters label any surprise to the economy an exogenous shock, an unpredictable event that can't be programmed into an econometric model. That's why the destruction of the World Trade Center and the damage to the Pentagon leave the outlook more unknown than at any time since World War II. History simply cannot tell us how American consumers and business will react over the next few quarters to a crisis of this magnitude.

CONSUMERS FREEZE DURING CRISIS

EVENT	DRDP IN CONFIDENCE
1973 OIL SHOCK	-53.4
1980 CREDIT CONTROLS	-35.8
1987 STOCK MARKET CRASH	-14.9
1990 GULF CONFLICT	-47.0
1998 LTCM COLLAPSE	-18.9

POINT CHANGE IN INDEX OF CONSUMER CONFIDENCE

Data: Conference Board, *BusinessWeek*

ation, to January, 1991, the end of the war.

Keep in mind, though, that about 300 Americans were killed during that conflict. The current disaster surpassed that total in its first few seconds. Moreover, the Persian Gulf War was fought on foreign soil. The tensions generated by this at-home attack are greater and will linger longer.

CERTAINLY, THE TERRORISM is forcing immediate changes to the way business is conducted. After the attack, travel was suspended, sporting events canceled, business offices closed, and the financial markets were shut down. All that represents a huge volume of lost economic activity.

On a positive note, policy actions at home and overseas will help to keep business going. The Federal Re-

serve announced that it is ready to inject liquidity into the system as needed. The Bank of Japan and the European Central Bank pumped a total of \$80 billion into their markets. The united front stabilized the dollar after it plunged on the day of the attack.

The outlook over the next few quarters, however, will come down to how U.S. consumers and businesses behave. Typically, their response to a crisis has been to freeze. Spending stops, and decisions about the future are put on hold. If this disengagement lasts only a few days, then the economy will probably soldier on—still weak, but growing.

But given how the attack has shattered U.S. complacency, the impact will likely persist. If so, capital spending, already falling like a stone, seems apt to decline even more, and consumers will be more likely to save their rebate checks than spend them. In an economy already weakened by inventory problems and rising unemployment, any new suspension in overall demand will mean the end of the expansion and a further reduction in profit expectations that will fall back on stock prices.

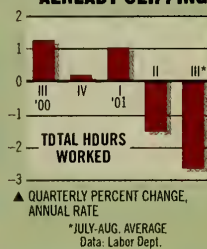
THE ECONOMY WAS TEETERING

even before the disaster (chart). The most recent data came in mixed, as they usually do when the economy's fortunes are about to change. Factory numbers showed that tech continued to struggle, but old-line manufacturers were getting a better handle on their excess inventories, and their orders were picking up. Consumer confidence fell early in 2001, but it had stabilized at a still historically high level. Profits continued to swoon, but the tax rebate checks were boosting the aftertax income of households.

Then on Sept. 7, the economy got some bad news. The August employment report said that nonfarm payrolls fell 113,000, and the unemployment rate bounced up to 4.9%, from 4.5%. The unexpectedly large job loss unnerved investors, who had been looking for better economic news. Instead, the Dow Jones industrial average closed down 235 points for the day, bringing the losses since mid-August to about 800 points. Higher joblessness and the market plunge had undoubtedly hit consumer and business confidence hard.

Easily the most downbeat news from the August em-

THE ECONOMY WAS ALREADY SLIPPING



ployment report was the continued large drop in hours worked, which in the first two months of the third quarter were down at a 2.6% annual rate from their second-quarter average, well faster than the 1.5% drop in the second quarter. The September number will make the quarter's decline even worse, especially since the World Trade Center disaster happened during the Labor Dept.'s survey week. A 3% drop in hours worked means that productivity would have to grow at a 3% annual rate just to bring economic growth to zero.

For the first time this year, the possibility of two consecutive negative readings on gross domestic product cannot be ruled out, since the fourth quarter may well be at risk in the aftermath of the Sept. 11 events. Moreover, the skimpy 0.2% gain in the second quarter could yet be revised down.

CONSUMERS WERE GETTING SKITTISH before September. August chain-store sales increased, but only at a modest pace. (Buying was expected to be up strongly because of the tax rebate checks.) In addition, consumers took on no new credit in July after paying down their debts by \$1.8 billion in June. That was the biggest two-month pullback in borrowing in nine years. Households may already have been concentrating on sprucing up their finances rather than spending more.

Will consumers completely retrench now? Again, the gulf war offers a discouraging example. Real con-

sumer spending fell at a 1.2% annual rate in the second half of 1990. Factor in the new job worries (table), and consumers have every reason to cut back on their spending.

If that's the case, then this recession could be a prolonged one. Capital spending will offer no help, since businesses were already grappling with an overhang of equipment. Foreign trade is unlikely to be a buffer. If anything, the U.S. may turn more protectionist in coming months. The one source of growth may well be the government, especially funds for the military and rebuilding.

Before Tuesday, the consensus view of economists was that the U.S. would muddle through this sluggish time and that the worst was over. Now we are in uncharted waters. Consider that most recessions are the result of exogenous shocks: the oil crisis of 1973, the credit controls of 1980, and, of course, the gulf war. This time around the shock—so sudden, so deadly, and so near—opens a new door in U.S. history and a new chapter in the economic outlook.

WHERE JOB LOSSES SO FAR HAVE BEEN CONCENTRATED

	CHANGE THROUGH AUGUST
NONFARM PAYROLLS	-36
PRIVATE	-342
MANUFACTURING	-804
MACHINERY	-304
CONSTRUCTION	87
SERVICES	357
GOVERNMENT	306
THOUSANDS	Data: Labor Dept.

FRANCE

MODEST GROWTH, BUT A WIDENING BUDGET DEFICIT

France's economy will hold up better than most of its euro zone neighbors' this year, but it has not escaped the slowdown, and economic fallout from the terrorist attack on the U.S. could make matters worse.

In particular, France's public-sector finances are deteriorating.

Real gross domestic product rose only 0.3% in the second quarter from the first, after gains of 0.5% in the winter and 0.6% at the end of 2000. Falling exports and weak business investment meant manufacturing slowed further last quarter, as did consumer spending.

France is expected to grow 2.25% this year, down from 3.4% last year, and about a half-percent

faster than the expected euro zone pace. But the price of that performance will likely be an overshoot in its public-deficit target for 2001 and 2002. Past tax cuts and the economic slowdown

have cut revenues, so the central-government deficit through July widened by 11% from the same period a year ago.

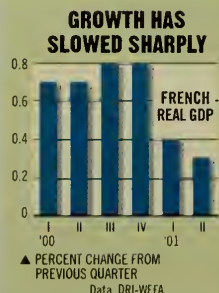
Last year, France cut both its value-added tax and fuel taxes. This year and next, with the Socialist government

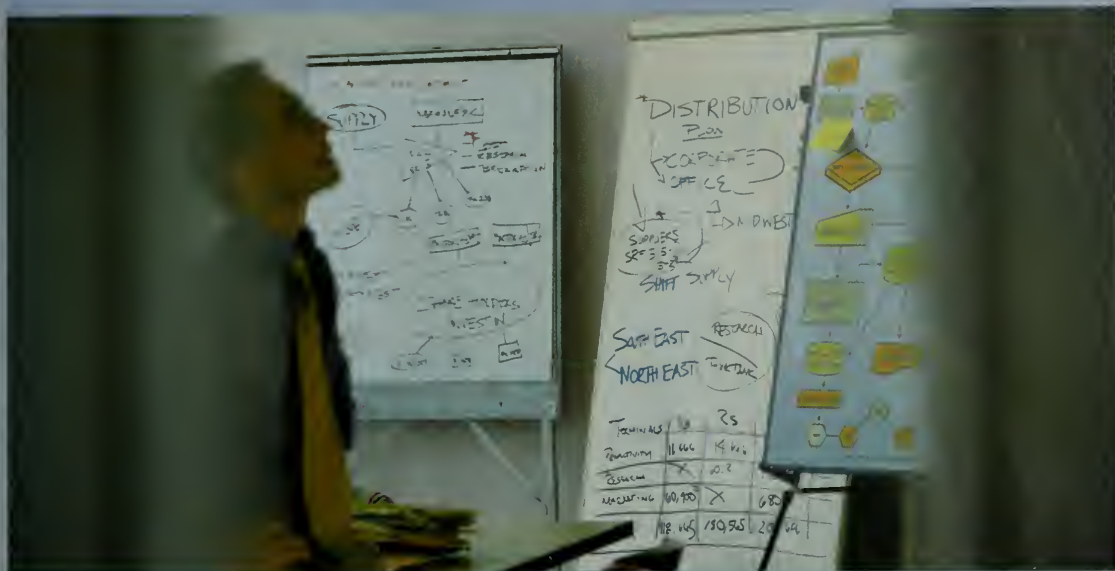
caught between an economic slowdown and elections next spring, more cuts in income taxes—plus a back-to-school benefit and a one-time rebate—will attempt to buoy both consumer spending and the

ruling party's election hopes.

With slumping global demand now likely to skid further, the outlook depends on consumers. However, consumer confidence has already dipped sharply, and that happened before the larger-than-expected surge in July unemployment, the third monthly increase in a row. The jobless rate rose to 8.9% in July, after holding close to a two-decade low of 8.7% for most of the year.

Economists at J.P. Morgan Chase & Co. project that France's deficit will swell to 1.6% of GDP both this year and next, double the government's current projection. The European Commission has already admonished France, Germany, and Italy over this growing trend. But with the outlook so uncertain, these governments have little choice.





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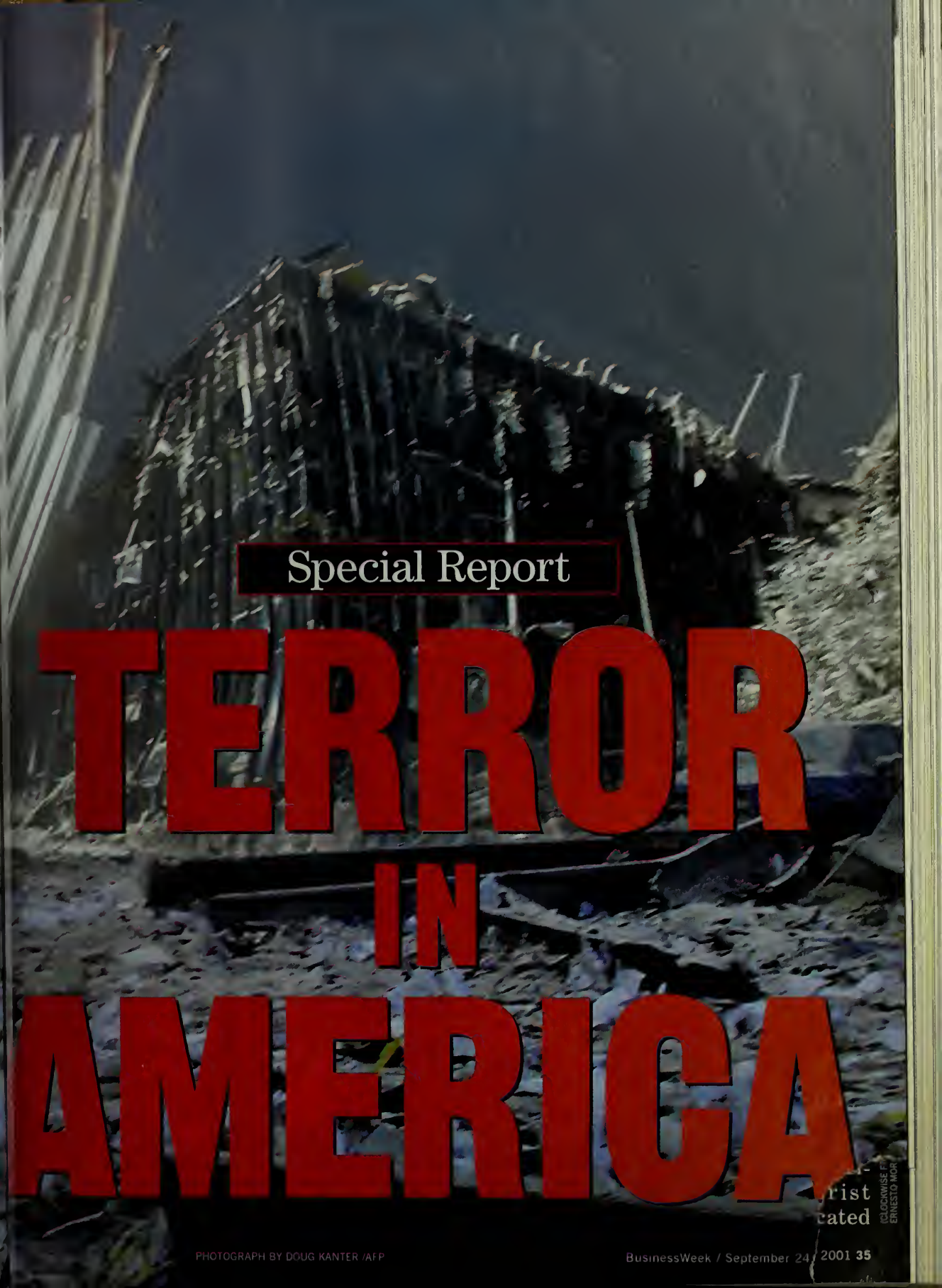
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Special Report

TERROR IN AMERICA

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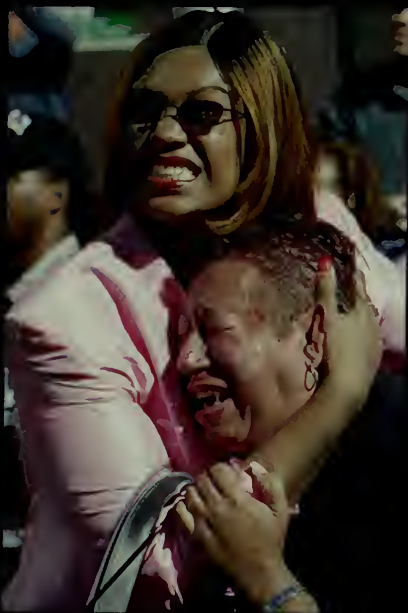
(CLOCKWISE FROM
ERNESTO MORENO)

PHOTOGRAPH BY DOUG KANTER /AFP

BusinessWeek / September 24, 2001 35

TERROR IN AMERICA





O

nce in a great while, an event occurs that is so horrific that it sears its way into the national psyche. It happened on Dec. 7, 1941, with the Japanese raid on Pearl Harbor, a surprise attack that left the U.S. Pacific fleet in flames and Americans' sense of invul-

nerability shaken.

Now, nearly 60 years later, the nation has been rocked by a new day of infamy. On what began as a crisp and sunny Sept. 11, 2001, terrorists launched a devastatingly well-coordinated assault on the very symbols of American economic and military might—the twin towers of Manhattan's World Trade Center and the Pentagon complex.

The carnage was unimaginable, as the list of casualties soared far beyond the handful of losses the U.S. suffered in full-scale military operations such as the Persian Gulf war and the Bosnian intervention. This was 21st century conflict, a hellish, home-brewed variety—and suddenly, it was unfolding on American soil.

Close your eyes and try to make the images go away—the jagged holes ripped in the twin towers by two hijacked airliners, desperate office workers jumping to their deaths, the buildings' eventual cascading collapse, scenes of panic in the streets, jumpy TV footage of injured Pentagon officers. You can't banish the horror.

Chances are, the generation of Americans who come after us won't be able to, either. This terrorist operation, a sophisticated



CLOCKWISE FROM LEFT: PHOTOGRAPHS BY SUZANNE PLUNKETT/AP/WIDE WORLD; ERNESTO MORAN/WIDE WORLD; CHIP EAST/SIPA PRESS

strike that U.S. intelligence sources suspect may be the work of Islamic radicals, was too great a blow to the nation's sense of security. "This is a lot harder to process than Pearl Harbor," says Columbia University historian Alan Brinkley. "It will shake the way Americans think about their place in the world. We have thought of ourselves as protected. Now that we have experienced this kind of terrorism, it will be hard to restore that sense of safety."

America's wartime response certainly underscores the point. In the aftermath of the attacks, troop convoys rolled through the streets of Washington. Military jets crisscrossed the skies above Manhattan. U.S. airports and financial markets were ordered temporarily closed, and government buildings were evacuated. Skyscrapers in commercial centers were also shuttered, and the country seemed to be under siege, its citizens uncomprehending in the face of the invisible threat. A grim President Bush, appearing at a national security meeting on Sept. 12, bluntly labeled the attacks "acts

of war."

But by whom? And how, when shadowy extremist cells are involved, can a U.S. military more accustomed to deploying sophisticated Stealth bombers and cruise missiles against its adversaries respond? As *BusinessWeek* went to press on Sept. 12, answers were sketchy, the questions many: How could a U.S. intelligence apparatus that had long braced for violence by agents of renegade Islamic leader Osama bin Laden and other Middle Eastern radicals have let such a complex attack unfold? After the hijackings of four U.S. commercial planes—two American Airlines jets and a pair of United Airlines jetliners—can any traveler assume it's safe to fly again? Even if the attackers failed to crash a hijacked airliner

into the White House, how could they have managed to hit the nearby Pentagon? Are corporate skyscrapers things of architectural beauty—or particularly vulnerable targets? And how much of Americans' cherished sense of individual freedom and unfettered mobility will now be sacrificed to the imperatives of internal security (page 54)?

Beyond these immediate concerns, larger issues loom. Even if the terrorists' bloody rampage ends without a second wave of assaults—which is by no means clear—Terror Tuesday will exact a psychic and economic toll on the nation. Before the attacks, the economy was already teetering on the

brink of recession and consumer confidence was flagging (page 42). Now, the prospect of a guerrilla war raging inside U.S. borders threatens a short-term bout of economic paralysis as Americans halt much of their normal activity to absorb the enormity of the tragedy. If confidence weakens further, anemic retail spending could send the U.S.—and with it the global economy—into a deeper decline and heighten the sense of unraveling.

In that sense, the audacious suicide raid constitutes a sharp new blow to an American economy that has already had to weather a yearlong manufacturing slump, a tech meltdown, a tumbling Dow Jones Industrial average, and a spike in energy prices that now stands to be repeated. If the terrorist strikes and expected sharp U.S. military retaliation create more instability in the seething Middle East and the Terrorist Crescent that spans Pakistan and Afghanistan, a temporary oil-price jump could stretch into a protracted problem—not just for the U.S. but for an Asia and Europe that are struggling with slowdowns of their own.

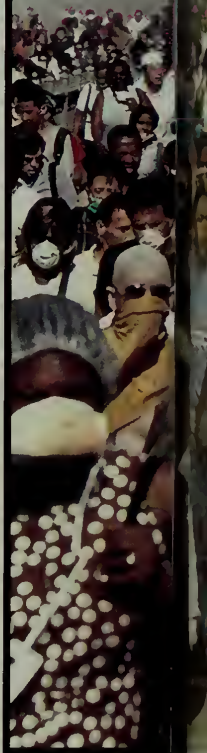
RENEWED SCRUTINY. That's why the crisis looms as a double-barreled challenge for the fledgling Bush Administration. Even before the billowing smoke of terrorist attacks transformed the landscape of Washington and Manhattan into scenes reminiscent of Jerusalem or Sarajevo, the White House's management of the economy was facing increasing skepticism, with bipartisan talk rising in Congress that a "second stimulus package" might be needed to fend off a deep slump. Now, the President's foreign-policy stewardship faces a severe challenge as well. In brief remarks on Sept. 12, Bush sought to radiate resolve. Calling the battle against terrorism "a monumental struggle of good vs. evil," the President vowed: "Make no mistake... we will win."

Although Americans traditionally rally behind their political leaders and put partisan squabbles aside in times of emergency, it won't be long before both Bush's leadership and communications skills come in for renewed scrutiny. For starters, critics will home in on the apparent collapse of U.S. human intelligence and raise questions about the vigilance of the FBI and the new antiterrorism task force headed by Vice-President Dick Cheney.

The U.S. debate on defense and national-security strategy will profoundly shift as well, transformed from a spat over "lockboxes" and funding levels into a deeper debate about priorities. Although Bush and congressional hawks will game insist that the terrorist strike underscores the need for an

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NEW DAY "It will shake the way Americans think about the

Welcome to Manhattan

RUDOLPH W. GIULIANI
MAYOR
C. VIRGINIA FIELDS
BORO PRESIDENT



missile shield to defend against rogue states, Democrats will counter that the \$8 billion Bush seeks as a first installment on his Star Wars antimissile system would be better spent on shoring up domestic security and military readiness. While Democrats might achieve a short-term tactical victory by delaying some of Bush's missile-defense money, liberals' dreams of a wholesale assault on big-ticket Pentagon weapons will also go up in smoke. At a time when the nation is under attack, few lawmakers will be emboldened to push massive program cuts. Fortunately for a President still very much in on-the-job-

training mode, Bush's bench is deepest on the defense and national security side. Veep Cheney, Defense Secretary Donald Rumsfeld, National Security Adviser Condoleezza Rice, and Secretary of State Colin Powell are a veteran crew of savvy hands. Although the group doesn't always mesh smoothly, its performance in the Administration's initial foreign-policy crisis—the capture of a straying U.S. reconnaissance plane by China—was both subtle and successful.

CAN HE STEP UP? But ultimately, the response to the nation's bloodiest encounter with domestic terrorism is too important for Bush to delegate to subordinates. Thus, a taciturn politician who has been notably shy about appearing before the national TV cameras will now be forced to constantly provide the American people with reassurance and vital information. This role—part healer, part authority figure—was something Bill Clinton managed with aplomb in the wake of the 1995 Oklahoma City federal-building bombing. Whether a Dubya who appears uncomfortable in his cameo TV turns can rise to the occasion remains to be seen.

Bush's desire to be seen as a kind of flinty, "Silent Cal" Coolidge figure may not survive the public's hunger for leadership—and answers—in the wake of Tuesday's tragedy. And the changes won't end there. Bush's entire world view may also have to be altered in the face of new realities. Up to now, the President has practiced a kind of Reaganesque unilateralism that led him to a "damn the opposition" view in advancing U.S. global interests. In addition, the Texan passed up few opportunities to declare that other nations' internal woes were not U.S. strategic concerns.

It is precisely this inward-looking fixation that led Bush to conclude that the Mideast was a sinkhole to be skirted. Indeed, attempts at U.S.-mediated peace accords and global conclaves of all stripes were ridiculed by the Administration as Clintonesque exercises in fanciful idealism. But at 8:45 a.m. on Sept. 11—the time the first commandeered airliner crashed into the World Trade Center—Bush's desire for international detachment may have ended for good. The need for a coordinated global response to countries that fund or harbor terrorists "will hasten Bush's reengagement with the world after a campaign in which he pledged to step back from U.S. interventionism," says Bruce Buchanan, a University of Texas political scientist.

Just as he learned that a quick, surgical U.S. withdrawal from the Balkans was not realistic, Bush is about to discover that a U.S. pullback from vigorous mediation of the Arab-Israeli conflict is a stance he can ill afford. Now, the Mideast's problems are American problems. Now, the casualty lists are no longer distant tallies of Israeli teenagers killed by Hamas suicide bombers or rock-throwing Palestinian youths cut down by Israeli gunfire. The war has come home.

It is war with no face and no name, a struggle that is not marked by the traditional massing of troops or the sound of distant trumpets. But make no mistake: It's a war just the same, and the potential casualties are many. Among them: America's post-cold-war innocence, George W. Bush's not-so-grand illusions, and the health of the global economy.

By Lee Walczak, with Alexandra Starr and Richard S. Dunham in Washington, and bureau reports

BusinessWeek online

For continuing coverage of the attacks and their aftermath, go to www.businessweek.com/today.htm

ce in the world," says a Columbia University historian



TEST OF FIRE *The terrorist attacks offer Bush a chance to convince doubters that he can lead the world's most powerful nation*

THIS C

From the budget to missile defense to a go-it-alone foreign policy

George W. Bush's go-it-alone approach to foreign policy just came to an abrupt halt. Tuesday's exploding jetliners, crumbling skyscrapers, and unspeakable human carnage made it forever clear that terrorism doesn't just happen "over there." As instantly as the twin airliners plowed into the World Trade Center, the nation's political and policy debate was transformed completely and profoundly. Just days earlier, Bush was squabbling with congressional Democrats over spending priorities. Now, such issues seem trivial. Against the backdrop of a nation under attack, Bush must convince the country and the world that he has the political skill and resolve to forge a swift and powerful response to this new terrorist threat.

As awful as the attacks were, they provide Bush with a unique opening rally U.S. allies—and the world in general—against terrorism. That will require him to work closely with European governments that until now have been largely put off by Bush's unilateral approach. At the same time, the Bush Administration will pressure nervous moderate Arab leaders to crack down on the extremists who operate within their borders (page 58).

In the jittery U.S. capital, everything seems to be on the table. The inside-the-Beltway blame game over the disappearing federal surplus has already given way to a bipartisan crusade to protect the nation from future attacks. The mayhem in New York and Washington, where a third plane slammed into the Pentagon, also gives Bush plenty of political cover to dip into the Social Security trust fund to finance a military modernization. But he will surely have to readjust his priorities. Missile defense, for one, becomes a much harder sell. So-called "homeland defense

NGES EVERYTHING

suddenly seems far more relevant. Before the attack, lawmakers had agreed to address underfunding of intelligence and disaster response. But now, amid congressional investigations into the colossal intelligence and security breakdowns that failed to anticipate the attacks, Bush will no doubt look for much more funding to boost intelligence activities and protect the U.S. against chemical and biological warfare.

The Administration faces other tricky challenges, too. Arab Americans are already on edge about the prospect of a widespread and violent backlash as well as a new round of racial profiling by law enforcement. Bush's attempt to liberalize immigration policy could be another casualty. Civil libertarians fear that new security measures will compromise traditional American freedoms. While the President on Sept. 12 tried to assure Americans their "way of life" won't change, it's a promise that may prove impossible to keep.

If Bush navigates these treacherous waters successfully, he could redefine the Presidency and silence skeptics who doubt his ability to handle foreign affairs. But that's a lot to pull off. Six

years ago, Bill Clinton's sensitive response to the Oklahoma City bombing marked a turning point in his then-unpopular Presidency. For Bush, says University of Virginia government professor Larry J. Sabato, "this could be his Oklahoma City to the 10th power."

The President clearly has not mastered the power of TV, but he must nonetheless find a way to unite Americans and restore their confidence in both the faltering economy and their personal security. Americans traditionally come together in an international crisis. Indeed, after Bush's trio of brief speeches on Sept. 11, 64% of Americans say they were confident of his ability to handle the crisis, according to an Ipsos-Reid poll. "But if this becomes a crisis without resolution, it will be dangerous for him," says Columbia University historian Alan Brinkley.

FRIENDS NEEDED. That's why Bush needs to quickly reverse the transatlantic drift that has characterized his early Presidency. And on this issue, Europeans are likely to link arms with the U.S. Despite deep disagreements over missile defense, global warming, and other issues, Bush can count on Europe to

back U.S. action against their common terrorist foe.

America has always enlisted European allies in retaliating against terrorism abroad. Now, that terrorism has struck home with such devastating consequences, the President will need more military and intelligence cooperation than ever from NATO nations. "We're going to want all the friends we can find in the world to be on our side in isolating the people who did this," says Chester Crocker, a top State Dept. official in the Reagan Administration. That's more likely than ever, agrees Nicole Gnessotto, head of the European Union's Institute of Security Studies: "You're going to see the two sides [of the Atlantic] stick together completely, and there will be a big push to cooperate much more on intelligence."

One key Bush "friend" could turn out to be Russian President Vladimir V. Putin. A decade ago, Soviet leader Mikhail Gorbachev was vital to President George H.W. Bush's international coalition against Iraq. Now, Putin, who has battled rebels funded by Osama bin Laden in Chechnya, is reaching out to the younger Bush to "unite in



PENTAGON DAMAGE "Homeland defense" will be a buzz phrase

THE NEW REALITY

The terrorist attacks on Sept. 11 have quickly revised the policy framework in Washington. Among the new priorities:

DITCHING UNILATERALISM

A hallmark of early Bush Administration foreign policy has been a pull-back from previous U.S. involvement in hot spots such as the Middle East. Now, Washington needs to demonstrate its leadership to secure cooperation from other countries and to thwart terrorist networks.

PROTECTING THE U.S. AT HOME

Congress is certain to go along with Bush demands to increase funding for airport security and counterterrorism operations. The Feds may also push for relaxing wiretap restriction and other privacy protection.

RETHINKING STAR WARS

Protecting against threats on earth suddenly becomes more urgent than protecting from theoretical attacks from space. Billions once targeted for Star Wars could be redirected toward intelligence operations and combating other terrorist threats such as chemical and biological warfare.

TABLING THE BUDGET DEBATE

While Bush will be under pressure to retaliate, he will now also have political cover to dip into the Social Security surplus to fund massive increases in Pentagon spending and counterterrorism.

SUDDENLY, spending hikes for the Pentagon, the CIA, and other security-related agencies are a near certainty

the fight against terrorism."

The American tragedy also will draw Bush deeper into the complex web of Middle Eastern politics, something he tried to avoid in the early months of his Presidency. Recently, the Administration has prodded Israel and the Palestinians to curb the violence that has left the peace process in tatters. If the New York and Washington attacks are linked to terrorists bent on holy war in the Middle East, Bush will be under enormous pressure to take an aggressive role in mediating. Former Senator Warren B. Rudman (R-N.H.), a member of an international commission aimed at restarting peace talks, says the panel would like to see Bush more involved. "Unless this [Palestinian] situation is brought under control, it will spread in many ways—and we've seen one [on Sept. 11]," he says.

SHIFT IN FOCUS. At the same time, America's allies will continue to exert pressure on Bush to shelve his missile-defense plan. Already, skeptics at home say there isn't enough money to protect against both attacks from space and those closer to the ground, and the danger Star Wars is designed to thwart—rogue nations with nuclear weapons—is less urgent than the risk of attack by terrorist cells working across borders. "This should be a wake-up call to reorient our national-security threat assessments away from future missile threats and toward earth-bound, here-and-now threats," says Joseph Cirincione, a defense expert at the Carnegie Endowment for International Peace. Still, missile-shield advocates won't relent without a fight. "This is something you've got to do," says Kenneth Adelman, a Reagan Administration arms-control negotiator. "We have plenty of money for what's important."

Just days before, such big-spending boasts would have been scoffed at on Capitol Hill. The military budget looked like a juicy target for Democrats seeking more domestic spending and Republicans seeking a new round of tax cuts. The White House was in a political bind because the President had promised re-

peatedly on the campaign trail not to raid the Social Security trust fund to finance government spending. A *Washington Post/ABC News* poll taken just prior to the attacks found that a phenomenal 92% of voters wanted to protect Social Security under any circumstances.

Everything looks different now. "The first thing we've got to do is defend this country," says Senate Budget Committee Chairman Kent Conrad (D-N.D.). "That's got to be the priority." The Bush Administration will ask Congress to beef up spending on airport security, which many lawmakers have long complained is too lax. Although Congress in recent years has spent nearly \$250 million on equipment to screen luggage for bombs, most of the machines have been idle

the CIA and FBI. "Why is it we were not able to pick up any of this, not even a whiff or a phone call?" says Senator Chuck Hagel (R-Neb.). Terrorism experts advocate a clean sweep of those in charge. "All of the heads of all the counterterrorism units should be removed and [CIA Director George] Tenet should be fired," says Michael Lundine, a terrorism specialist at American Enterprise Institute. "You can't just say: 'Try harder.' They've already demonstrated they're incompetent."

Indeed, Congress may create a job to oversee the war on terrorism. The new post would direct "homeland defense" measures designed to thwart terrorist threats and coordinate a rapid response to any violence that does occur.

The costs of homeland defense "are not going to be trivial," notes Leon Fuerth, national security adviser to former Vice President Al Gore. Still, he concludes, the plan "needs to become a reality."

SECURITY FIRST. These fast-changing priorities in Washington will also complicate matters for Corporate America. The Senate recently passed business-backed legislation to loosen curbs on exports of computers and other high-tech goods over the strong objections of law-enforcement agencies. The House version of the proposal is much more restrictive. After the attacks, business is likely to persuade House leaders to bend. And corporate efforts to roll back unilateral U.S. sanctions against rogue nations such as Libya, Iraq, and Sudan now seem destined for defeat.

For a tentative President in the chaotic aftermath of the Sept. 11 terror offers a real opportunity to break out of his isolationist mold. Indeed, Bush has little choice but to take the lead on global stage he long sought to avoid even as he calms and guides a worrisome nation. That would be a tall order for even the most seasoned politician. For George W. Bush, they're the challenge of a lifetime.

By Richard S. Dunham, Andrew Borrus, and Stan Crock in Washington with bureau reports



AT THE U.S. EMBASSY IN PRAGUE *Washington will need all the friends it can find*

because airlines balk at paying for the staffers needed to use them or the longer wait times travelers would face. Fumes House Aviation Subcommittee Chairman John Mica (R-Fla.): "A lot of the [airport] security measures are for show. There isn't enough emphasis on the real risks."

An overhaul of U.S. intelligence looks likely, too. After the massive failure of America's spies and eavesdropping systems to uncover the unprecedented attacks, Congress is pointing fingers at



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TOO SHAKEN TO SHOP After the attack, customers deserted Rodeo Drive in Beverly Hills

WORLDWIDE, HOPE FOR RECOVERY DIMS

Economic shock in the U.S. may trigger a global recession

The National Association for Business Economics was holding its annual meeting in the Marriott Hotel at the World Trade Center when disaster struck. "The chandeliers shook, we heard a concussive sound, and as we were herding out, we could see that one tower was burning," says Carl Tannenbaum, the chief economist of LaSalle Bank in Chicago, who was attending the meeting.

Just the day before, a panel of NABE economists had predicted slow growth, but no recession. That forecast was obsolete, however, the moment the first plane hit. In addition to destroying thousands of lives and billions of dollars in property, the terrorist attacks forced the shutdown of the financial markets, the temporary closure of U.S. businesses, and the grounding of air passenger and cargo traffic. Around the

country, customers vanished from stores. With the U.S. already near zero growth, these impacts themselves are almost certain to tip the country into negative growth. "People are going to pause. And that pause is going to have a real impact on the third quarter and probably the fourth quarter," says Fred Poss, chairman and CEO of American Standard Companies.

If the experience of the August, 1990, Iraqi invasion of Kuwait is any guide, consumer confidence and spending are likely to plunge. In the four months after the Iraqi attack, the Conference Board index of consumer confidence dropped by 40%. Consumer spending held up a bit longer, but it, too, eventually tanked, hitting its low in January, 1991.

This crisis could be even worse. "We'll see a huge drop in consumption," predicts Brian S. Wesbury, chief economist at Griffin, Kubik, Stephens &

A GROWING THREAT? Further terrorist attacks and military retaliation could start a cycle of turmoil, forcing countries to put up barriers to travel and trade

Thompson Inc., a Chicago investment banking firm. Before the attack, Wesbury expected third-quarter GDP to fall at a 0.3% rate. Now he expects it to drop 1%. The stock market could dive as well, as a contracting economy drags down profits by as much as 10% to 15% in the fourth quarter.

A U.S. downturn will have repercussions all around the world. With Japan imploding economically, Asia in trouble, and Europe struggling, a recession in the U.S. would remove the last remaining source of demand from the global economy. "It's like throwing cold water on any prospects for a recovery," says Chang Il Hyung, senior vice-presi-

ent of South Korea's Samsung Electronics Co., the world's largest memory chipmaker. With people around the globe watching the carnage in New York, consumer confidence and business investment could be hit everywhere. Since the global economy is intertwined, rough trade and investment, all of us will be worse off," says Sung Won Sohn, chief economist at Wells Fargo & Co. Not everyone agrees. "My initial reaction is that it won't have a significant economic impact," says Lawrence A. Bossidy, chairman and chief executive officer of aerospace and industrial giant Honeywell International Inc. "Unnecessarily, this is negative" in the short term, adds Minoru Makiyama, chairman of Mitsubishi Corp. But "unless there is a series of continued attacks, there is a chance that things will settle down in a few days or weeks."

It is possible for the economy and fi-

nancial markets to bounce back strongly from negative events. The 1990 Iraqi invasion pushed down stock prices by 15%. But after U.S. tanks started to roll, markets rebounded sharply. That signaled the start of the 1990s' bull market, notes Steve Leuthold, chairman of Leuthold Weeden Capital Management in Minneapolis.

The long-term impact depends on whether the attack is a onetime event or the start of a new period of high uncertainty. The danger is that further terrorist attacks and military retaliation could start a cycle of turmoil, forcing dramatically tightened security and new barriers to travel and trade.

UNCHARTED WATERS. Those restrictions would strike the heart of the global economy, which depends on open borders and open markets. "The process of globalization is based on the idea that the world economy can be secured against threat," says Philip Poole, chief economist of emerging markets at ING Barings in London. "This has now been undermined." Adds Joseph E. Stiglitz, a Columbia University professor and former chief economist for the World Bank: "The borderless world through which goods and services flow is also a borderless world through which other things can flow that are less positive."

All this has the U.S. economy entering uncharted waters. "We're really going to go through a period in our country where things are never going to be the same," says Marvin J. Girouard, chairman and CEO of Fort Worth's Pier 1 Imports Inc.

Part of what makes this tragedy different is the unimaginable human and emotional devastation of the World Trade Center collapse, which makes its eventual impact on the economy much harder to predict. "When events become too complex and move

too rapidly, human beings become demonstrably less able to cope," Federal Reserve Chairman Alan Greenspan said in a speech in 1998. "The failure to comprehend external events almost invariably induces disengagement, whether it be fear of entering a dark room or of market volatility."

There may be a tendency to overreact. "Will there be a form of mental panic, with consumers feeling that everything is liable to come apart?" asks Louis Schweitzer, CEO of France's Renault. If consumers and executives hesitate before making spending decisions in the short run, the auto industry, for one, would suffer. After record sales of 17.3 million vehicles in 2000, most industry executives had looked for sales to slow to a rate of about 16.5 million units for the rest of this year. Now, says David L. Littmann, chief economist at Comerica Bank in Detroit, auto makers will be lucky to see a 15.9 million sales rate in the second half. "Consumers are far less confident than they

were a year ago," adds George Pipas, director of sales analysis for Ford Motor Co. "The potential impact is cause for concern."

The struggling information technology industry is at risk as well. "I'm really concerned about the timing," says Frank C. Huang, chairman and CEO of Powerchip Semiconductor Corp., a Taiwanese producer of memory chips for customers such as Mitsubishi Electric, IBM, and Hewlett-Packard. Powerchip had been hoping for an upbeat fourth quarter, which traditionally accounts for 35% to 40% of total PC sales. Now that seems less likely. "People just won't be in the mood for Christmas shopping," says Huang.

They probably won't be eager to buy new homes, either, if the uncertainty lasts more than a few weeks. After

THE ECONOMIC IMPACT

The World Trade Center and Pentagon attacks are likely to have far-reaching financial and economic effects:

► Falling consumer confidence will drag an already stagnant U.S. economy into recession

► U.S. economic contraction could make recovery difficult for weak European and Asian economies

► Declining profit expectations will pull down global markets and increase financial volatility

► The U.S. may lose its reputation as a safe haven, reducing foreign investment and driving down the dollar

► More stringent security measures could boost the costs of trade and travel over the long-term

Iraq invaded Kuwait, new single-family housing starts fell by more than 25%. A similar drop this time could hit one of the few remaining pillars of economic strength in the U.S.

So far, one positive is that the price of oil has stayed stable. The supply of oil has not been interrupted, unlike 1990, when the Iraqi invasion temporarily

and manufacturing orders fell 1.4%.

The bad news doesn't stop there. The biggest losers are likely to be in non-Japan Asia, argues Frank F.X. Gong, a Hong Kong currency strategist at Bank of America. "Over the medium term, if you do have a prolonged slowdown, Asia will be hurt very badly, because Asian countries are the most export-

ior of the dollar. Given the mammoth trade deficit, most economists agree that the dollar will eventually fall. That would make imports more expensive and U.S. exports more competitive. But despite that expectation, foreign investors have continued to pour hundreds of billions annually into the U.S. They have been attracted, in part, by

reputation as a stable country with fast growth. The resulting flows have provided cheap financing for U.S. investment and consumption while buoying the dollar.

ROSY RUBLE? The attack triggered a near 2% slide in the dollar against the euro. If that continues, foreign investors would be more reluctant to put their money into the U.S., leading to higher interest rates and worsening of the U.S. recession. "In periods of uncertainty, the U.S. is normally seen as a safe haven," says ING's Poole. "But the dollar is at risk in the environment." One sign of this: When the news of the attack first came out, there were long lines outside currency exchange points in Moscow as Russians ran to sell dollars for what they temporarily saw as a safer currency—the Russian ruble.

Facing such a crisis of confidence, the dimensions of U.S. economic policy needs are obvious. On the monetary side, the Fed did the right thing by sending a message that it stands ready to provide additional liquidity, says F. Ward McCarthy Jr., managing director at Stone & McCarthy Research Associates in Princeton, N.J. The morning after the attack, the Fed injected \$38 billion into the money market, compared with the normal \$5 billion. It told the central banks of the U.S., Europe, and Japan pumped nearly \$10 billion into the financial markets on Wednesday to assure liquidity. On the fiscal side, the debates over the surplus will give way to more willingness to spend on defense. Moreover, President George W. Bush has asked Congress

dependent economies in the world."

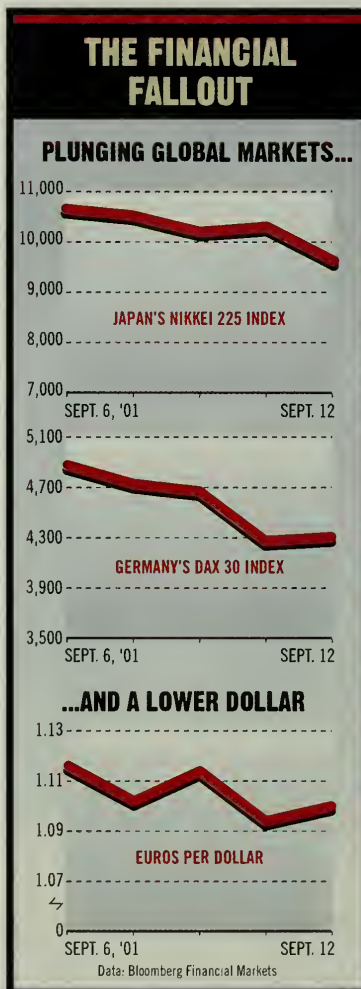
Meanwhile, the very functioning of the U.S. financial markets is a concern. Even when the stock and bond markets reopen, the damaged financial system faces a daunting backlog of orders. At the same time, insurance companies will have to pay out claims amounting to tens of billions of dollars, forcing them to raise money by selling assets or issuing large quantities of bonds. "Can the financial system handle all these problems?" asks Sohn of Wells Fargo. "At least temporarily, the financial system could be frozen, further damaging the economy."

The economic wild card is the behavior

of the dollar. Given the mammoth trade deficit, most economists agree that the dollar will eventually fall. That would make imports more expensive and U.S. exports more competitive. But despite that expectation, foreign investors have continued to pour hundreds of billions annually into the U.S. They have been attracted, in part, by

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authority to spend whatever it takes to deal with terrorism. That will stimulate the economy, too.

But in this situation, the political and military response is as important as the economic one for maintaining confidence. For the economy, "it usually doesn't matter what the President says—but his time it will," says Griffin, Kubik's

Wesbury. "If we can be tough and show some reaction to this, we can avoid a long-term impact on the economy."

Once it became clear, in 1991, that the U.S. was winning the gulf war, confidence and consumer spending rebounded, and the recession ended a couple of months later. But with the enemy far more elusive and the U.S. econo-

my already struggling, the ending may not be so neat this time.

By Michael J. Mandel in New York, with Laura Cohn in Washington, Joseph Weber in Chicago, Christine Tierney in Frankfurt, Stephanie Anderson Forest in Dallas, Catherine Belton in Moscow, Amy Barrett in Philadelphia, and bureau reports

MADISON AVENUE GETS GRIMMER

In those far more innocent days before Sept. 11, Acirca Inc., an organic-food company based in New Rochelle, N.Y., was readying a massive campaign to give away free samples of its Walnut Acres line of soups and salsas. Starting on Sept. 15, youthful workers were to fan out in New York and Seattle to hand out goodies to thousands of consumers, hoping to introduce the brand and its healthy-lifestyle message.

That was then. Now the sampling blitz is on hold because of stepped-up security in the crowded urban areas where sampling works best—and because the mood among consumers is likely to turn more sober and reflective. "We try to create an environment that's educational and entertaining, but that's hard to do when the country has been devastated by an act of terrorism, confidence has been destroyed, and people feel vulnerable," says Michael Neuwirth, Acirca's corporate communications director. **TIGHT WALLETS?** In a country already gloomy about its economic prospects, the attacks likely will mark the abrupt end of the free-spending zeitgeist of the 1990s. As shocked Americans come to grips with just how dangerous the world can be, there is a real risk that they will further cut back on the spending that has sustained the economy so far this year.

In that climate, marketers' exhortations to indulge in ostentatious spending, make minute distinctions among equivalent brands—or even adopt a healthier lifestyle—could ring hollow. For marketers already on the fence

about maintaining budgets, it could be tempting to dial back ads reaching out to a distracted and depressed public. It all adds up to a new blow to ad spending that had been slumping for months. Just two weeks ago, Merrill Lynch & Co. media analyst Lauren Rich Fine revised her ad-



spending projections for this year from the 0.7% decline she forecast in June to a steeper 4% drop. For 2002, she sees a tepid 1% uptick.

The situation is reminiscent of a decade ago, when the gulf war drastically damped travel and other business activity, crushed consumer confidence, and prompted marketers to "defer" ads. Often, they promised to restore spending, but that year's 2% decline showed that few did.

Are we in for a replay? Marketers are just beginning to grapple with the new reality. At Snapple Beverage in White Plains, N.Y., the first reaction was to rush drinks to an emergency staging area. Later could come debate over whether to proceed with several new products—including one with a suddenly inaccurate image of the New York skyline cut into the glass bottle, says

chief marketing officer Michael Sands.

Certainly, the immediate impact was extensive: retail shutdowns, canceled entertainment and sporting events, postponed business meetings. There were rumblings that TV networks, already losing millions as news crowds out ads, might delay

GLOSSIES: In the shadow of terror, appeals to spend could ring hollow

the Sept. 17 start of the ad-rich fall season. Leisure and travel, makers of autos and appliances, all could hold off on spending, at least for now. "There could be a fear factor, a retrenchment, a thought of not wanting to take risks," acknowledges Ellis Verdi, president of New York agency DeVito/Verdi.

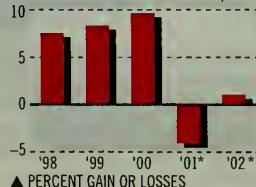
Expect a change in tone, as marketers abandon the frivolous appeals to self-indulgence of the boom years for an emphasis on family, community, patriotism, and other enduring values. "Marketers will be afraid to use black humor right now, since there is nothing funny or whimsical about thousands dying," says Marian Salzman, global director for strategy and branding at Euro RSCG Worldwide. "Kinder and gentler" will be the new theme. Think Hallmark cards vs. Sony PlayStation."

For now, marketers and their agencies are putting on their bravest face. "Our lives have changed, and we don't know how yet, but we have great confidence in the American economy," says Steven G. Felsher, vice-chairman of Grey Global Group Inc. As Americans sort through those larger issues, ad campaigns likely will come back down to earth, in tone and in spending.

By Gerry Khermouch in New York

MARKETING TAKES A BACK SEAT

Even before recent terrorist attacks, marketers had cut back on ad spending



*2001, 2002 PROJECTED BEFORE SEPT. 11
Data: Merrill Lynch & Co.

THE VIEW FROM GROUND ZERO

Some small firms blasted out of existence were key players

One moment, Joseph F. Campbell Jr., an analyst at Lehman Brothers Inc., heard the unexpected whine of a plane. The next, he watched the aircraft crash into One World Trade Center, sending many to their deaths. Engulfed in smoke, Campbell got out of Lehman's headquarters in the nearby World Financial Center, alive but shaken. "Our colleagues who worked in the Trade Center tower are less fortunate," he says. "We all are going to have friends who died in the fires."

When terrorists leveled the World Trade Center, they did much more than destroy a landmark. They obliterated the offices of Wall Street investment banks, mutual funds, and hedge funds (page 12), where thousands were preparing for the stock market to open at 9:30 a.m. Juggernauts including Morgan Stanley Dean Witter, insurer Aon, Bank of America, and Lehman scrambled to locate legions of brokers, traders, and technicians based at the World Trade Center. "It's just devastating," says Richard H. Repetto, a research analyst at Putnam Lovell Securities Inc. "The World Trade Center was the symbol of American capitalism."

WIPED OUT. At some firms, many escaped before the buildings collapsed. Morgan Stanley said a high percentage of its 3,500 workers at the complex were safe. But their offices were wiped out. And many smaller outfits, such as investment banking boutiques Keefe, Bruyette & Woods and Sandler O'Neill, feared they had lost between one-third to two-thirds of all of their employees.

Many foreign firms also lost key parts of their operations. The U.S. headquarters of five major South Korean securities firms, including Hyundai Securities, and 16 Japanese banks, including Dai-ichi Kangyo and Fuji Bank, were destroyed in the blast. "The New York

subsidiary is our international operation's most important pillar," says Suh Jong Won, manager at Hyundai Securities in Seoul. "With the office wiped out, we'll have to give up business there for the time being."

Wall Street will never be the same. The loss of life is catastrophic in an industry that relies on personal relationships. In some specialties, business may be crimped for months because of the loss of traders and analysts. Nasdaq worried that 19 of its 32 market makers in the Twin Towers were lost. Cantor Fitzgerald, which made roughly a quarter of the \$300 billion of daily trades in U.S. Treasuries, feared it had lost almost all of the 1,000 employees at its headquarters. "Wall Street will be able

to resume when the switch is [turned] on," says Ray Soifer, an independent banking consultant. "But not every firm."

Even Merrill Lynch & Co. and Goldman, Sachs & Co., whose offices were not reduced to rubble, may find their operations crippled for months. Engineers fear that the Wall Street's infrastructure has suffered

grave damage that may not be fully apparent even after the wreckage has been cleared up. Consider the communications networks on which the Street depends. Verizon Communications said on Sept. 12 that 20% of the New York Stock Exchange's high-speed data lines were out of action, and the rest were operating only sporadically. "The area of attack is probably the most telecom-intensive spot in the world," said Larry Babbio, vice-chairman and president of Verizon's telecom group. "This could be a very long process."

Wall Street's large firms say they were ready to cope with the stock market's planned Sept. 17 reopening. Most have offices around the globe and extensive backup systems. "A lot of the

CONTINGENCY PLANS Many outfits can set up operations elsewhere, using duplicate records



LUCKY ONES LEAVING A TANGLED

firms have contingency plans for setting up operations elsewhere, and they have duplicate records," says Robert Pickel, executive director of the International Swaps & Derivatives Association. Lehman used its London and New Jersey offices to coordinate the evacuation of 6,000 staff from its headquarters in the World Financial Center, across to

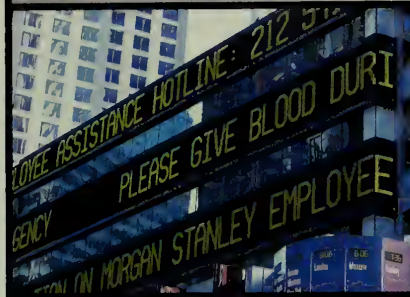


fallout from this will be incredible"

reet from the disaster. Morgan Stanley moved fast to reassure clients. "In spite of this tragedy, all our businesses are functioning and will continue to function," said CEO Philip J. Purcell in a statement. "All our clients should rest assured that their assets are safe." Still, the backup systems won't solve the woes Wall Street faces. For a start,

be a terrible mess" sorting out the transactions, says Steven C. Leuthold, a Minneapolis money manager.

Every day the markets operate at less than full speed, Wall Street's earnings will be cut. Securities firms earned about \$800 million in revenues daily in the second quarter, according to statistics from the Securities Industry Assn.



AFTERMATH An armored personnel carrier patrols Wall Street. Uptown, Morgan Stanley appeals for blood donors

And those revenues are more important than ever to bankers as they wrestle with a stock market stuck in a decline, a dearth of initial public offerings, and dwindling numbers of mergers and acquisitions. "You could have some further damage to financial markets in the near term, which would simply continue the trend on the Street of declining business volumes," says Guy Moszkowski, a financial-services analyst at Salomon Smith Barney.

VAST SCALE. But that may be the least of Wall Street's worries. Some analysts figure it may be months before the Street begins to overcome the trauma of the Sept. 11 attacks—because of the sheer scale of the human tragedy. "The fallout from this will be incredible," says Putnam Lovell's Repetto. "It's going to take a while to recover."

And the longer that takes, the longer the world's biggest economy will have to wait for Wall Street to raise the billions of dollars it needs to get back on track and pull the rest of the world out of its funk.

By Emily Thornton and David Henry, with Steve Rosenbush in New York and Stanley Holmes in Seattle



BROADWAY TICKET BOOTHS When will all the tourists return?

ON THE DISABLED LIST: NEW YORK

The rebuilding will be slow—and the loss of revenues huge

In Times Square, nobody was shopping. Hours after the attack on the World Trade Center, the tourists were too afraid. "Half the people in the hotel were completely panicked," said Charles Velez, a concierge at the neighborhood's DoubleTree Hotel. "They didn't even want to go outside." On the door of the adjacent Palace Theater hung a loose-leaf paper sign: "Due to today's tragedy, tonight's performance of *Aida* is canceled." Broadway was dark the next day as well.

The terrorist attack brought the city's economy to a halt, and it may be some time before it revives. "New York depends so much on its flows—people, goods, services," says Steven G. Cochrane, a regional economist at researcher Economy.com Inc. "It's such a hub. But right now, it's an isolated island, completely cut off." As a result, Cochrane thinks almost every major New York industry will be hurt: tourism, financial services, retailing, and real estate.

HUNGRY HOTELS. Tourism will take the most immediate hit. New York & Co., which promotes tourism, estimated that 38 million visited the Big Apple last year, spending \$17 billion and supporting 282,000 jobs. Hotel vacancies had already been climbing this year as hotel-

iers added 3,500 new rooms and the economy softened. Convention-planning agencies say they're getting panicked calls about upcoming conventions, but so far, none have been canceled.

Damage to the financial services industry—with 522,000 workers, the city's No. 1 employer—may be severe. Brokerage earnings will take an immediate hit because of the Wall Street shutdown. "Even when trading desks do reopen, financial transactions will be drastically reduced," says Ross C. DeVol, regional economist at the Milken Institute, an economic think tank in Santa Monica, Calif. "The people who assist the traders will have a hard time getting to work." The entire sector contributed \$207.5 billion to the city's \$444.4 billion in output last year.

Already, the Big Apple's economy was slowing after a decade of robust growth. Before the attacks, Economy.com forecast that the growth in the 4 million-plus workforce would sink from a brisk 2.6% rate in 2000 to just 1.3% this

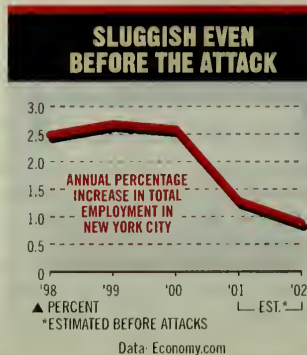
year because of layoffs at brokerage firms and banks. It put likely 2002 employment growth at 0.9%. Coming ahead of the Thanksgiving-Christmas season when the retail and tourist industries book a large chunk of their business, the attacks may cost thousands of jobs. "Who's going to want to travel to New York now to see a show or shop at Bloomingdale's?" asks Cochrane.

The business loss will also deplete New York's tax coffers. According to the city comptroller's office, in fiscal 2000, the last year for which data is available, the city's total tax revenue grew 5.7%, to \$22.5 billion. Some \$3.1 billion came from sales taxes at retailers and tourist attractions. An additional \$5.4 billion was collected in personal income tax. "Of that personal income tax, 15% came from Wall Street employees, much of it from big year-end bonuses," says Ronald H. Fielding, a New York municipal bond fund manager at Oppenheimer Funds. Because of smaller bonuses and lower sales, he expects fiscal 2001's revenues to be flat. But with Wall Street and tourism hard hit, the coming 12 months could be much worse. **"EASY TARGET."** Sadly, the only sector that could actually benefit from this disaster is real estate. According to the Real Estate Board of New York, the World Trade Center had 9.5 million square feet of office space out of a total of 360 million in Manhattan. That means 2.6% of New York's office space is on the market. With just an 8% office vacancy rate, that's a significant number. Businesses desperate for a new home will have to pay a premium. Prime Manhattan office space was already at \$65 a square foot before the disaster, but a spokesperson at real estate manager Cushman & Wakefield says the firm now has "dozens of clients looking for space."

Long-term, however, New York's commercial real estate market could suffer. "It used to be good for business to be in a high-profile building in New

York," says Leo Welch, president of Welch Real Estate Fund. "Now, it makes you an easy target." The danger is that companies might find their temporary quarters on the side of New York more to their liking—and never come back.

By Lewis Braha, with Michelle Conte, Tom Lowry, Susan Scherrek, and Andrew Tergesen, in New York



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A RUINOUS DAY FOR INSURERS

The World Trade Center losses could bankrupt some

When Hurricane Andrew ripped through South Florida in August, 1992, it was a sobering reminder of the human and the financial price Mother Nature could exact. Now Andrew has a ghastly rival. As people registered the shock of Tuesday's destruction in New York and Washington, whippers began within insurance circles that the attacks might cost insurers as much as \$30 billion. Until now, Andrew's \$16 billion tab was the most expensive U.S. insurance event ever. "This is catastrophic beyond anything we've ever seen in the U.S.," says Jason B. Adkins, a partner in Adkins, Kelston & Zavez, a Boston law firm that specializes in insurance litigation.

The insurance bill will surpass the record for a man-made catastrophe, the \$775 million loss from the Los Angeles riots, also in '92. Certainly, the insurers in this case have spread their risk. "Insurers don't even insure an aircraft alone," says Robert P. Hartwig, chief economist at the Insurance Information Institute in New York. The American Insurance Assn., a trade association of large commercial insurers, expects that almost all of the major U.S. companies will have some losses. Industry experts estimate that hundreds of insurers around the globe share the risk in this case, though it's unclear whether, after the 1993 bombing of the World Trade Center that cost insurers \$510 million, the new policies covered terrorism differently from other risks.

Even if some terrorism exclusions are in place, it's clear that there will be billions in losses for the industry. Already European reinsurers, companies that insure other insurance companies, have begun to calculate their exposure to the building damage, claims

for injured workers, lost business income, and the cost of temporary relocation. Giant Munich Reinsurance has put its exposure at \$907 million, a number the company says would severely hurt profits. Its stock fell sharply along with those of Swiss Reinsurance and Allianz



DEVASTATION Workers sifting through the rubble of 1 World Trade Center. The insurance bill may set a record

the day of the attack. Stocks of American insurers were expected to be down sharply when U.S. trading resumed. Berkshire Hathaway alone expects to shoulder 3% to 5% of the cost.

Some firms are likely to face bankruptcy, particularly smaller reinsurers that might have taken on more risk than they can pay for. "I'm sure there will be some carriers who won't be able to withstand the loss they're exposed to," says Matthew C. Mosher, group vice-president for A.M. Best Co., the insurance-rating firm.

Property and casualty rates are sure to rise—since Andrew, they have jumped by 250% in Miami and by 110% in all of Florida.

Analyst Ira L. Zuckerman of Nutmeg Securities Ltd. expects to see a similar increase in reinsurance pricing now. The largest U.S. insurers, Allstate Corp. and State Farm, are less likely to be affected, as they do not specialize in commercial insurance. Instead, observers worry about commercial specialists such as American International Group Inc. and Loews Corp.'s CNA Financial unit. AIG Chairman M.R. Greenberg said in statement: "Our total losses stemming from this tragedy will not impact our solid financial condition." CNA said its exposure was "under review."

The greatest risk may be facing companies that cover health costs, life, and

workers' compensation. Unlike property insurers who face a maximum replacement cost, workers' comp and health insurers face potentially unlimited costs, and claims that will extend beyond the tenant of the Trade Center. This is of special concern in the case of workers' insurance because that industry has already been experiencing a dangerously high level of insolvencies and sharply reduced earnings, says insurance-rating firm Weiss Ratings Inc.

The biggest New York writers of workers' comp are AIG and Liberty Mutual.

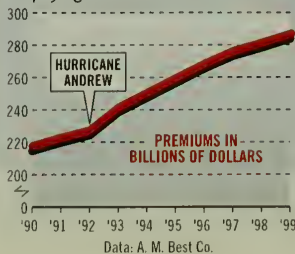
So a disaster like this one is likely to have a winnowing effect. After Hurricane Andrew, A.M. Best lowered its ratings of 31 of the 230 companies most exposed, and several small ones failed.

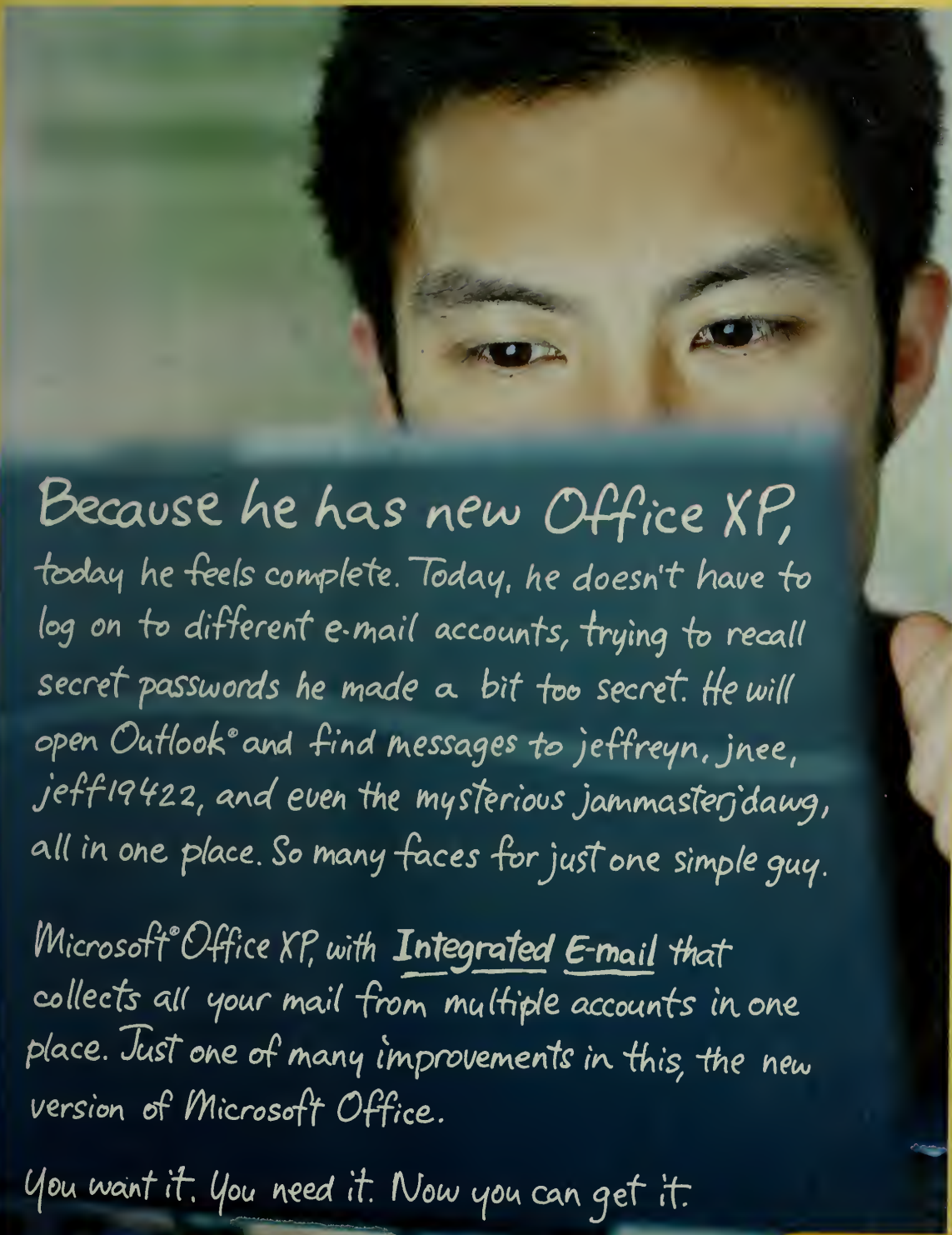
But those that didn't saw premiums—and their stock prices—climb. "This is kind of a sick industry that regard," says Best's Mosher. For insurers and the customers, the dust has only begun to settle.

By Nanette Byrnes with Diane Brack in New York, Pallab Gogoi in Chicago, Kerry Capell in London, and David F. Lamb in Frankfurt

AFTER A HUGE STORM, THE BILL COMES DUE

Insurers have hiked property, casualty, and life insurance rates sharply since paying Hurricane Andrew claims





Because he has new Office XP,
today he feels complete. Today, he doesn't have to
log on to different e-mail accounts, trying to recall
secret passwords he made a bit too secret. He will
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jeff19422, and even the mysterious jammasterjdawg,
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HOW MUCH HEAVIER CAN THE BAGGAGE GET?

The airlines' fortunes go from bad to really bad, fast

Airlines were already having a bad year. Now, after the deadly hijackings of four aircraft, things have gotten much worse. Skittish travelers will try their best to avoid flying, probably for months, and airlines will have to spend hundreds of millions, to boost security. That means the industry is unlikely to turn a profit again until at least 2003. Although American Airlines and United Airlines, which lost two jets each and 266 people, may be hardest hit, no airline will be untouched by the events of Sept. 11.

Even before the terrorist attacks, airlines were suffering big losses from a falloff in high-fare business travel compounded by rising labor and fuel costs. Just four days earlier, AMR, parent of American Airlines and Trans World Airlines, warned it would lose "considerably" more in the third quarter than the \$105 million it lost in the previous three months. Analysts then predicted the industry would lose as much as \$3.5 billion this year. As for next year, the Air Transport Assn. warned that losses could approach \$2 billion. After the hijackings, those numbers will almost certainly rise. "It's one really disastrous thing on top of what was already a difficult year," says Michael E. Levine, a former airline executive who's now a Harvard University law professor.

As consultants and analysts try to determine the long-term impact of the hijackings, they're looking back to the Persian Gulf War in 1990-91. Then, as now, the economy was in deep trouble. Oil prices were surging, and a frightened public was refusing to fly. The industry lost \$13.1 billion over five years—more than it had earned since the start of commercial aviation.

The impact from this latest catastrophe could be as great or greater, since it

travel in the U.S.—a first. Some flight resumed Sept. 12. Once the FAA allows all planes to take off again, it likely will be days before airlines can reassemble their fleets and crews. Airport security will be tighter, travel will be slower. The Transportation Dept. banned curbside check-ins late on Sept. 11. That was just one way airlines shorted security in favor of convenience. "As we've increased efficiency by decreasing human interaction, we have to ask, 'Have we made ourselves vulnerable?'" says Marian McInerney, executive director of the National Business Travel Assoc.

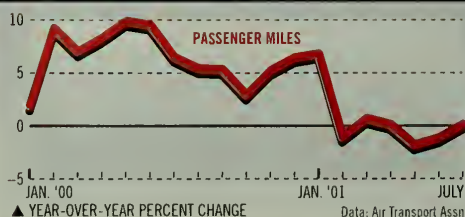
Airlines will be under pressure to improve safety in other ways. Typically, they have contracted out security to firms that pay their guards little more than minimum wage. Now airlines will have to offer higher salaries to attract better-qualified screeners. And by the end of this month, the FAA will begin to regulate security companies. Eventually, the heightened security and added personnel will mean higher fares.

The decline in ticket sales and the increase in expenses could push some smaller carriers over the brink. Midway Airlines Corp., which had declared bankruptcy in August,

went out of business on Sept. 12. The other discount airlines have gone bust in the past year. "Some of our small brethren may not make it," says Samuel D. Addoms, chief executive of Frontier Airlines Inc. In the airline industry, things just went from very bad to horrific.

By Michael Arndt in Chicago and Lorraine Woellert in Washington

U.S. AIRLINES' GROWTH WAS ALREADY STALLED



involved hijackings in the U.S. on domestic flights, something once considered unthinkable. Kevin P. Mitchell, chairman of the Business Travel Coalition, conducted a survey of corporate members on Sept. 11. Of the 187 who responded, 62% said they would prohibit any travel until at least Sept. 16, and 88% predicted employees would voluntarily curb travel after that.



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THE COSTS OF FIGHTING TERRORISM

There's only so much that can be done—and much that shouldn't

In the days and weeks ahead, the U.S. will face tough questions about how to reduce the likelihood of future terrorist attacks. Experts on counter-terrorism say there are ways to strengthen the nation's security—but at a cost: Strengthening U.S. defenses would require billions in new expenditures and have a profound effect on privacy, travel, and other basic rights.

Many experts on terrorism say the U.S. needs to reassess the dangers and redistribute its resources. The nation must continue to prepare for exotic threats posed by nuclear, chemical, and biological weapons, they say. But it should devote more resources to fighting low-tech threats posed by airplane hijackings and home-made bombs like the one used in Oklahoma City. Among other things, that means tightening airport security to conform to what many European nations are already doing.

POISON GAS. It also means devoting more resources to intelligence gathering, using technology and trained agents to uncover terrorists' plans before they are put into effect. "The intelligence community has been starved for years," says retired General David E. Baker, managing director of Schwab's Washington Research Group and a member of the Joint Chiefs of Staff under President Clinton. "This will galvanize Congress to put partisan issues aside... and bolster intelligence."

Much of U.S. research on antiterrorism until now has focused on nuclear, chemical, and biological weapons—and that won't change. The disintegration of the Soviet Union sparked urgent fears about the possibility of Soviet plutonium falling into terrorists' hands. The release of poisonous sarin gas in a Tokyo subway in 1995 highlighted the horrors of chemical weapons. And officials are stepping up efforts to be prepared for a biological weapons attack.

In June, Johns Hopkins, the Center for Strategic & International Studies, and others tried to predict what would

happen if terrorists released smallpox in three cities. By the time doctors identified the first cases, the terrorists would be long gone "and the situation was out of control," says CSIS fellow Sue Reinhold. Air travel and commerce would shut down. And within three months, estimates retired Air Force Colonel Randall J. Larsen, director of the ANSER Institute for Homeland Security, 3 million people would be sick—and 1 million of them

would die. "It spreads by a factor of 1 every two to three weeks," Larsen says.

But many devastating attacks in recent years—including the bombing of U.S. embassies in Africa and the Oklahoma City catastrophe—involved conventional weapons. "Short of shooting the plane down after it was hijacked there is nothing you can do," says Jason Pate of the Monterey Institute of International Studies in California.

NEW YORK DRILL

Localities need to improve their ability to respond to threats posed by biological weapons



BACKLASH

Some fear the government will place restrictions

That is where intelligence comes in. U.S. agencies have found it exceedingly difficult to penetrate terrorist groups, which may be built on family loyalties that stretch back generations. To break into such groups, security agencies may be forced to make increasing use of tactics many Americans find distasteful: paying terrorists to be informants. "If this is to be effective, we have to be willing to deal with those people who live in the alleys of the world," says Abraham Allison, director of the Belfer Center for Science & International Affairs at Harvard University and an assistant secretary of defense in the Clinton Administration.

It also means a stepped-up role for technology. Federal agencies already have vast authority to intercept communications and to place wiretaps. In 1979, Congress created a special court to consider domestic wiretaps in terrorism cases; it

approves roughly 1,000 a year and has rejected only one in its history (in a classified case). In 1994, Congress authorized \$500 million to subsidize phone companies to make their networks easier to tap.

The problem lies in interpreting and analyzing the intercepted data, says James X. Dempsey, deputy director of the Center for Democracy & Technology, a Washington (D.C.) civil-liberties group. "The intelligence agencies are awash in info," he says.

NO WARNINGS. Even so, information-gathering efforts are increasing. An FBI software program called Carnivore is capable of sifting through vast amounts of computer information. But it has met with fierce resistance from privacy and civil-liberties activists—and in the latest disaster, it yielded no warnings. Nevertheless, the recent attacks will provide new incentive to expand Carnivore, which can also monitor text messages sent by cell phone. And a federal mandate that goes into effect this fall will require most cell phones to automatically relay location data—providing useful information for 911 emergency services, but also allowing law enforcement to track individuals.

On the computer data front, the National Security Agency has already devised classified methods to uncover "keys" used to encrypt e-mail messages. But in the future, software makers could be asked to hand keys to the NSA. And then there's Echelon. This supersecret NSA eavesdropping operation monitors most electronic communications around the globe via satellite and ground stations. The NSA has a budget of \$7.3 billion and a staff of 38,000—more than the CIA and the FBI put together. Budget and staff are both likely to grow.

All these efforts, however well-intentioned, carry the risk of overreaction and a weakening of individual rights. "A lot of people are likening this to Pearl Harbor, where the immediate reaction was to round up Japanese Americans," says David Sobel, counsel at the Electronic Privacy Information Center. "I hope we don't have the same kind of overreaction"—this time using technology to infringe on human rights. Alan M. Dershowitz, the noted constitutional lawyer at Harvard Law School, says America is experiencing nothing less than a "paradigm shift" in how it balances individual rights and anti-terrorism. He anticipates calls for civil liberties to be curtailed. "Government will have greater freedom to conduct searches at

BALANCE SHEET

The following steps might reduce the likelihood of future attacks.

But each bears significant financial and social costs.

MEASURE	COST
Upgrade qualifications and training for airport security agents	Salaries and training costs
Restrict public access to some commercial centers and other areas	Crimps rights of travel and assembly
Increase surveillance of public places	Infringement on individual privacy
Expand government authority on wiretaps and other electronic snooping	Privacy and political risks, toll on quality of life
Counter bioterrorism by increasing efforts at Centers for Disease Control	Training and funding for research, readiness
Greater vigilance on storage and transport of nuclear materials	Salaries, training

airports and elsewhere. There will be less access to public places," he predicts.

We've already moved in that direction. Jay W. Waks, an employment lawyer in New York City, says background checks are allowed on any topic "so long as it is work-related." Employers have a nearly complete right to monitor employees' e-mail at work and their conduct on the job site (other than sensitive areas like bathrooms) as long as they warn employees they are doing so, Waks observes. One of the few forbidden practices is racial profiling of new hires by employers, says Erwin Chemerinsky of the University of Southern California Law School. "Airlines couldn't say, 'We aren't going to hire those of Arab descent.'"

The problem of fighting terrorism is becoming even more difficult because, more and more, it is the domain of fanatics with purely religious motives, says Jerrold M. Post, a psychiatrist at George Washington University who established an antiterrorist program when he was at the CIA. "In the last several



individual liberties in the name of fighting terrorism

years, in upwards of 40% of terrorist acts, no responsibility is claimed," Post says, most likely because the acts were committed by religious extremists. They don't need to claim responsibility, because they are not trying to promote a cause—they are simply attacking the West in the name of God, says Post, who just completed a study in which he interviewed 35 incarcerated terrorists in Israel. "Their clerical authority has told them this is a sacred act that will

gain them a higher place in Paradise." Infiltrating these groups is the only solution for the West, he says. And even then, the blight will never be stamped out. "You eliminate terrorists when you eliminate democracy," Post says.

Monterey Institute's Pate says the terrorist's game is psychological warfare. "They want us to believe our government cannot protect us." And in a sense, they are right. All the force of the American military will not protect

us from suicide bombers. The best way to fight this psychological combat is to celebrate the American way of life, to bolster American freedoms, and refuse to bend to the terrorist threat, authorities say. Declaring martial law or restricting Americans' freedom of movement will mean only one thing: The terrorists have won.

By Paul Raeburn in New York, with Mike France and Heather Green in New York, and bureau reports.

KEEPING THE BARBARIANS AWAY FROM THE GATE

Tightening U.S. airport security—which lags far behind that of Europe and Israel—will be central to U.S. antiterrorism efforts. It's also one of the biggest hurdles. Terrorism experts and government regulators have repeatedly found enormous deficiencies in this arena, but little has been done to correct the problems.

Classified reports prepared by the General Accounting Office and the Transportation Dept. earlier this year revealed that inspectors could easily bypass security and could have boarded planes with guns or explosives, officials say. They also note that none of the nation's 19 high-volume airports—which include Washington's Dulles International, Boston's Logan International, and Newark International—have run vulnerability checks recently.

One of the weakest links in the security chain occurs at the X-ray machines used to scan carry-on bags. The agents who monitor those devices are poorly trained and among the lowest-paid airport workers. "You try to get that job in the hope of getting a job at a fast-food place, which pays more," says a former government official. Turnover is high—complicating the issue of training.

OLD GEAR. Representative John L. Mica (R-Fla.), the chairman of the House aviation subcommittee who left a meeting at the Pentagon moments before the Sept. 11 attack, says airports also lack the latest gear. Since 1996, Congress has given the Federal Aviation Administration \$244 million to install explosives de-



SLEEPING WATCHDOG? Security at U.S. airports lags that of Europe and Israel

tectors in airports. The FAA has delivered 129 such machines to the nation's 400 airports. But there is a considerable lag time in getting these devices up and running, and it is not known how many are in use.

The FAA has just taken some incremental steps toward better security. Later this month, it will begin requiring that companies operating X-ray scanners and other security equipment be certified. And it is shipping out 1,400 new X-ray machines to all the nation's airports, at a cost of \$80 million for equipment, installation, and training. The new machines will monitor a screener's hits and misses, and those who do poorly will be pulled off and retrained. If companies don't meet

performance standards, they will lose their FAA certifications.

Nevertheless, for years, the agency overlooked some obvious risks. Until Sept. 11, the day of the terrorist attacks, it allowed passengers to carry on knives up to four inches long—which means the box cutters reportedly wielded by some of the hijackers were legal. On Sept. 12, it banned all carry-on knives.

SOFT DOORS. Lesson learned. And the next reform may be in aircraft construction. David Benoff, an editor at *Business & Commercial Aviation* (which, like *BusinessWeek*, is part of The McGraw-Hill Companies), advocates hardening airline cockpits. "The doors have an aluminum-honeycomb structure," he says. "I can kick that down."

At the least, U.S. airlines could take a cue from foreign carriers. In Japan, All Nippon Airways Co. is working with authorities to install a new generation of X-ray machines at airports. El Al Israel Airlines has security guards aboard all flights. All luggage undergoes special checks, and most pilots are former fighter pilots with training in handling emergencies. And airport security in Israel begins 1 kilometer outside the airport, with roadblocks and vehicle checks.

Such measures would complicate U.S. air travel and burden airlines. It is now up to the government and the public to decide whether those measures are worthwhile.

By Paul Raeburn in New York and Lorraine Woellert in Washington



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THE MIDEAST MAELSTROM MAY GET MUCH WORSE

As the U.S. focuses on terrorism, moderate regimes will come under heavy pressure

The horrific Sept. 11 attacks on the World Trade Center and the Pentagon are opening a new blood-soaked chapter in the difficult history of the U.S. in the Middle East. Although conclusive evidence is still lacking, intelligence agencies around the world point to Afghanistan-based Osama bin Laden, the renegade Saudi who has many admirers in the Arab world. Some also believe bin Laden and his followers may have acted in concert with a rogue state, possibly Iraq.

If the U.S. acts on these suspicions, the already dangerous situation in the Mideast could worsen immeasurably. Indeed, the U.S. could well adopt a far more militaristic and security-driven approach to the area and pay less attention to letting moderate Arab leaders save face. That could mean striking both at terrorists and at regimes that the

U.S. suspects of harboring terrorists, from Afghanistan to Iraq, Iran, and even Syria. What's more, Israel may get even tougher with the Palestinians now. "We must see to the collapse of the Palestinian Authority and even retake some territories controlled by the Palestinians," says Tsachi Hanegbi, Israel's Environmental Affairs Minister and a member of the Likud party.

An escalation of violence could be risky for both the U.S. and Israel,

however. The moderate Arab governments in the region are already under stress. If the U.S. lashes out blindly or mounts a massive military operation without regional support, that would put countries such as Jordan, Egypt, and Saudi Arabia under even greater pressure. "We could see some very bad fallout in terms of confidence and political stability," says Abdulrahman Al-Rashed, head of one of Saudi

Arabia's biggest merchant families.

Even before the World Trade Center cataclysm, ties between Washington and its Middle Eastern allies, including Saudi Arabia and Egypt, were strained. Leaders such as President Hosni Mubarak of Egypt and Crown Prince Abdullah of Saudi Arabia have blasted George W. Bush's aloofness about the region. And they don't think the U.S. has done enough to restrain Israeli Prime Minister Ariel Sharon's hard-line policy toward the Palestinians. To show his displeasure, Abdullah recently declined an invitation to visit Washington. Meanwhile, more than a few Arabs welcomed the Sept. 11 debacle as comeuppance for what they see as American arrogance. "The popular reaction is that these are the just rewards for American policy; people don't seem to think about the cost of innocent lives," says Aziz Abu Hamad, a Saudi analyst.

A major military strike and a hardening of American attitudes could widen the gap between the U.S. and the moderates. "My fear is that you will get a polarizing of attitudes," says a senior Western diplomat in Riyadh. "A



IN PAKISTAN
A bin Laden backer

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most anyone who comes from this side of the Mediterranean will be a terrorist. That doesn't bode well."

But many analysts think a sweeping change in the region is inevitable, even if it is uncomfortable for the Arab moderates. Washington is understandably likely to focus its attention and efforts almost entirely on countering terrorism. The response "will be massive and unrelenting," predicts retired U.S. Air Force General David E. Baker. "The message should be that we won't tolerate countries that support acts of terrorism against the U.S."

As the crisis escalates, the Saudis, who control much of the world's oil, are in an especially tough spot. They could well be pressed to allow their air bases to be used for massive attacks on Iraq and perhaps Iran, as well. They may also be expected to raise their output of crude oil to avoid price spikes—OPEC agreements be damned.

This won't be a pleasant choice for the Saudis. They fear the Islamic militants and would like to see them eradicated. But they also want to avoid kowtowing to Washington. "If it all starts boiling over, the region is going to face

declared Baghdad TV on Sept. 11. Despite the hostility between the U.S. and Baghdad, roughly a quarter of the oil that Iraq produces winds up in the U.S. A cutoff of Iraq's 3 million barrels per day in production could lead to price spikes, unless a steep economic downturn chills demand for oil.

At the moment, the oil markets don't appear too worried about a supply outage. Benchmark crude rose by an extraordinary \$3.50 per barrel, to \$31.00 on Sept. 11 in frantic trading. But it quickly gave up much of those gains. "Oil always rushes to judgement and

then feels guilty later on," says Peter A. Gignoux, head of the oil trading desk at Schroder Salomon Smith Barney in London. "The market recognized that there wasn't a supply disruption."

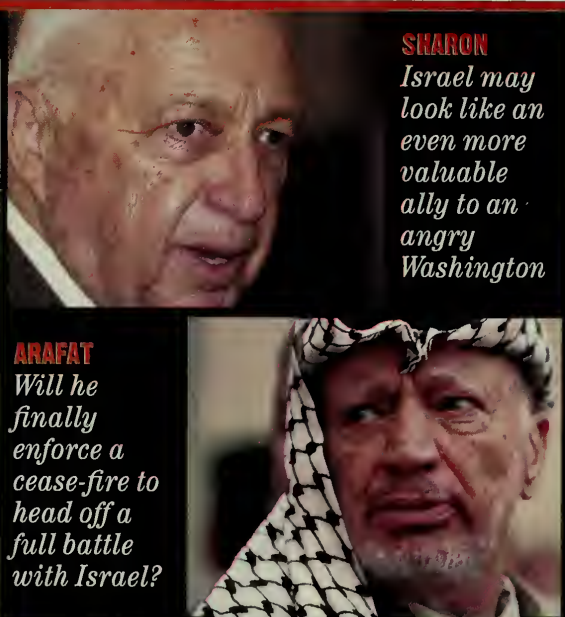
SAFETY IN NUMBERS. Of course, much depends on what the U.S. actually does. A prolonged series of raids or an armed incursion into Iraq would certainly ratchet up regional tensions, oil prices and rattle the regime in Afghanistan, the base bin Laden is remote, but a U.S. foray or massive raids there would also leave America vulnerable to charges that it was trashing yet another Muslim country, especially if the retaliation falls

THE MIDEAST FALLOUT

EXTREME POSITIONS WIN Israeli Prime Minister Ariel Sharon may step up his attacks on Palestinian targets, while Islamic fundamentalist groups and rogue leaders such as Iraq's Saddam Hussein are emboldened, creating more instability in the region.

MODERATES ARE THREATENED U.S. allies, such as Jordan, Egypt, and Saudi Arabia, could be caught between U.S. pressure to hit terrorists and demands of their own people to give more direct aid to the Palestinian cause.

U.S. MAY ACT The White House may be tempted to lash out at Islamic groups and attack suspected host regimes such as Iraq.



Longer-term projects such as resolving the Palestinian issue, which underlies much of the regional tension, would go on the back burner. "This is going to divide the world into camps of those who support the U.S. and its efforts against terrorism and those who do not," says Gerald Steinberg, a political science professor at the Bar Ilan University near Tel Aviv.

VALUABLE ALLY. Steinberg and others think that the attacks on the U.S. will increase American sympathy for the plight of the Israelis, who have been under siege by Palestinian suicide bombers. At the same time, Israel will seem an even more valuable ally to an angry Washington because it has long stressed terrorism as the key Middle Eastern issue and because it has useful military and intelligence assets. Indeed, sources in the Sharon government say they are already discussing ways to ramp up intelligence cooperation with the U.S.

some very difficult choices," says Raad Alkadiri, an analyst at PFC, Washington-based energy consultants. Simon Henderson, who runs the Saudi Strategic consultancy in London, thinks some of the more pro-American members of the Saudi royal family could seize the initiative from Abdullah, who has Arab nationalist leanings.

But the U.S. will be under pressure to use some caution in how it acts. American interests are likely to be entwined with the region—particularly the oil-rich Persian Gulf—for years. In fact, world dependence on gulf oil supplies has been growing because of the rising thirst for oil in North America and developing countries as well as the low rates of investment by the big oil companies.

The U.S. even has to be wary about how it deals with Iraq, the only Arab country that has welcomed the attacks. "The American cowboy is reaping the fruits of his crimes against humanity,"

to disable the bin Laden network. It would be much safer if the U.S. could put together a coalition—as it did after Iraq's Saddam Hussein invaded Kuwait in 1990.

Some Mideast policymakers think that fixing the Palestinian problem offers the best hope of soothing the resentment that fuels bin Laden's followers. The hope is that Palestinian leader Yasser Arafat will finally enforce a ceasefire to head off an intensified conflict with Israel. But even a peace deal may not be enough to stop bin Laden, whose hatred for the West goes far beyond the particulars of the Israeli-Palestinian confrontation. "With the best possible deal conceivable, he would still be out there trying to blow up airplanes," says the Riyadh diplomat. Terrorism without end. That's the most frightening prospect of all.

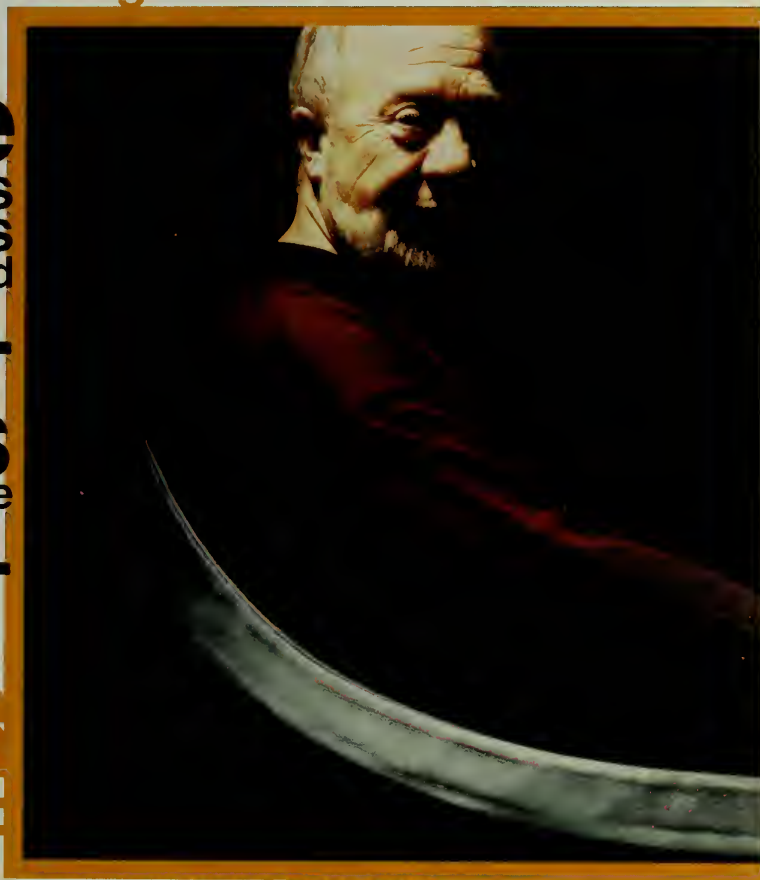
By Stanley Reed in London, with Neal Sandler in Jerusalem and Stuart Crock in Washington

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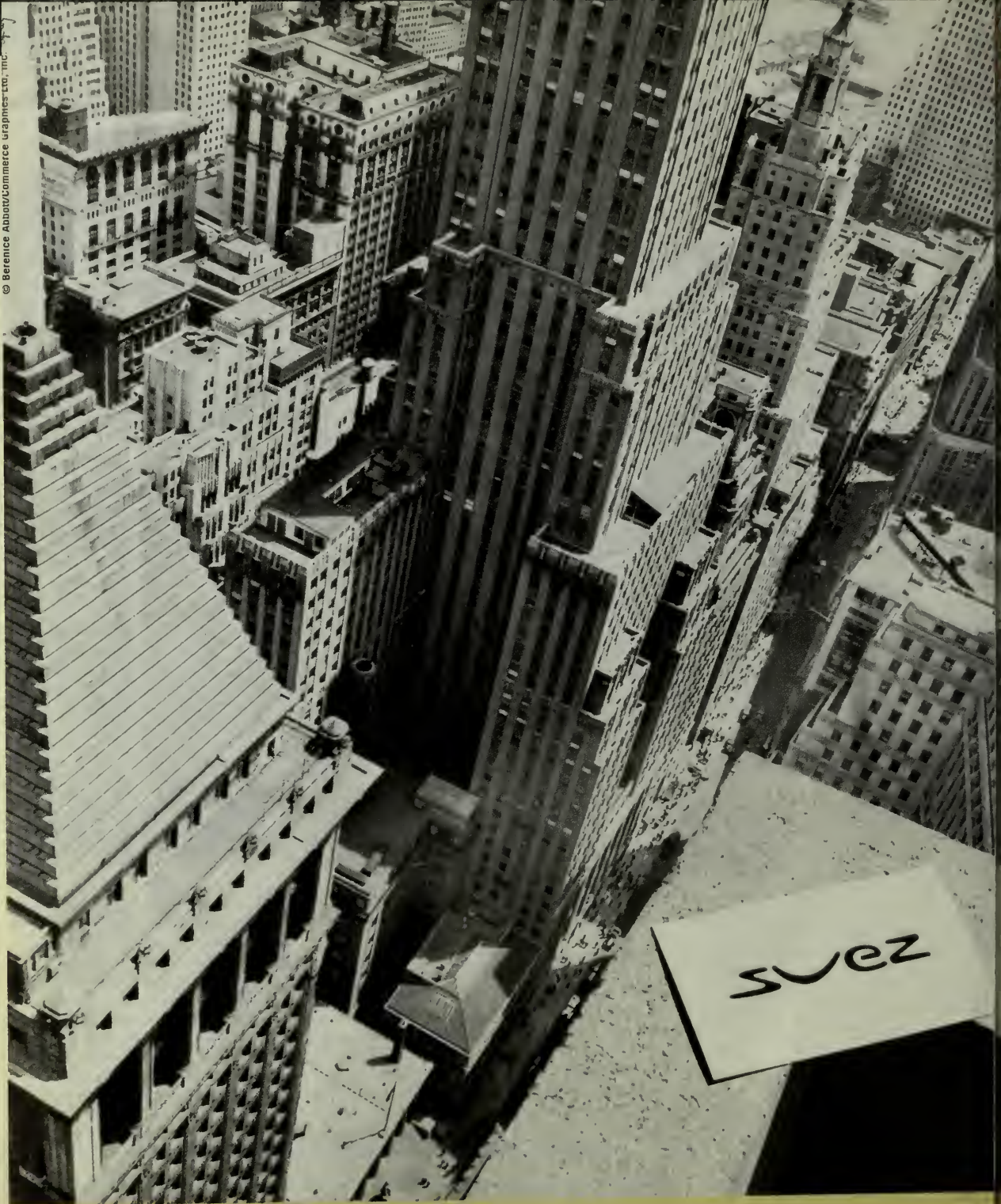
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EDITED BY OTIS PORT

GILA MONSTERS: CAN THEY SHARPEN YOUR MEMORY?

MEMORIES ARE MADE OF MANY things, and one of them may soon be Gila monster spit. Dr. Matthew During, a neuroscientist at Philadelphia's Thomas Jefferson University, has discovered that a peptide found in the saliva of these lizards can dramatically improve the memories of rats. The synthetic version, dubbed Gilatide, has been licensed to Axonyx Inc. in New York, which hopes the drug will be the first to successfully boost learning and memory, as well as provide help for people suffering from attention deficit disorder and age-related memory loss.

During's inspiration stems from research showing that various peptides released in the gut interact with memory receptors in the brain. This is probably an evolutionary adaptation that helped animals remember where they caught a tasty evening meal. He studied the saliva of Gila monsters because lizards sense prey with their tongues. Colin N. Haile, an assistant professor who works with During, says Gilatide produces impressive benefits in helping rats to remember how to run a maze. Just one administration of the drug resulted in very potent memory retention, which may last as long as 21 days, he says. Rats aren't people. But Gilatide could enter human clinical trials in a few years. *Catherine Arnst*



ON THE TRAIL OF "REVERSIBLE" POLYMERS

TOWERING PILES OF PLASTIC CONTAINERS AND TOYS AT landfills testify to the durability of polymers. Once the links are formed in the long chains of molecules that make up these materials, it's almost impossible to break the bonds and retrieve the original compounds. But by custom-designing new polymers and chemical processing techniques, engineers are closing in on keys to unlock the bonds—and on a new generation of recyclable plastics.

At the American Chemical Society's annual meeting in late August, Timothy E. Long, a chemist at Virginia Polytechnic Institute, described his work on molecules with "reversible architectures." If researchers can engineer the way polymers get glued together at the molecular level, he observes, "we should be able to take them apart."

Easier said than done. The task involves a huge investment in "mapping" the chemical behavior of molecules as they join together, or polymerize, over a range of temperatures. Doing this under controlled conditions provides essential clues to how the hydrogen bonds can later be undone. In addition to boosting the recycling of plastics, Long envisions newfangled adhesives whose stickiness can be reversed simply by applying heat. *Neil Gross*



FUEL-CELL CARS: COMING CLOSER—AND COMING FAST

SQUEAKY-CLEAN FUEL CELLS seem a sure bet to become a dominant source of power for everything from wristwatches to cars and even cities. That's because scientists have long since mastered the trick of converting hydrogen and oxygen into electricity and water. For fuel-guzzling cars, though, revamping service stations to handle hydrogen will take many years and billions of dollars. As an interim solution, researchers have turned to so-called reform-

ers—gadgets that extract hydrogen from fossil fuels.

Now, it looks like this costly stopgap technology may not be needed. Two University of Pennsylvania scientists, Raymond J. Gorte and John M. Vohs, have developed a fuel cell that "burns" hydrocarbons such as gas, natural gas, and even diesel fuel. Gorte and Vohs designed a modified fuel injector that sprays atomized hydrocarbon particles into a fuel cell to sustain the power-generating chemical reaction. There are carbon dioxide emissions, but Vohs says the amount is much less than that from an engine. So the new fuel cell could find its way into vehicles soon. *Adam Aston*

CHIPS ARE GETTING MARRIED AT MOTOROLA

THE SUMMER OF 2001 COULD go down as a major turning point in semiconductors, says Steve L. Cullen, chief silicon expert at market watcher Cahners In-Stat Group in Scottsdale, Ariz. He's not talking about this year's record-setting plunge in chip sales, now projected to drop 26% from last year—far eclipsing the standing worst-ever figure, a 17% fall in 1985. Instead, he's excited about Motorola Inc.'s disclosure that it has developed a way to dramatically boost production of high-performance semiconductors made from exotic materials—other than silicon—and to marry those with conventional silicon chips.

Silicon is used for about 95% of all chips. The other 5% are made from compound materials like gallium arsenide and indium phosphide. These offer much faster transistor-switching speeds, which are vital in mobile-phone handsets, for example. Cell phones have at least two chips—a nonsilicon one for processing wireless transmissions, and a silicon chip for everything else.

Gallium- and indium-based chips cost more than silicon circuits largely because they are made from wafers no bigger than 6 inches in diameter. Motorola can now crank them out on 8-inch silicon wafers. "But even more important," says Cullen, "Motorola's technology may enable hybrid chips" for one-chip cell phones.

Normally, silicon and compound materials can't be combined because the spacing between their atoms differs. This disparity creates short-circuit flaws. Motorola gets around that by putting a special buffer layer in between. The company is currently setting up a subsidiary to license the technology. ■

COMMENTARY

By Alan Hall

WHY THIS MAY CHANGE HEALTH CARE AS WE KNOW IT

On July 2, the first fully implanted artificial heart was stitched into the chest of Robert L. Tools, a 59-year-old technical librarian, at Jewish Hospital in Louisville. His failing heart had so debilitated him that doctors had given him less than 30 days to live; surgeons said at best, the high-tech device might double that number.

Well, 60 days have come and gone, and Tools has survived. His AbioCor heart, developed by Abiomed Inc. in Danvers, Mass., is a far cry from the technology of the 1980s, when volunteers died grim deaths tethered to pumps the size of washing machines. In contrast, the AbioCor is completely enclosed in the chest cavity, its pumping rate controlled by microprocessors, and its battery unit charged through the skin by a belt worn around the waist. With no wires or tubes connecting the heart to outside power sources, there are few openings for infection. Where the technology comes up short—the heart is heavy and too large to be inserted in children or in many women—advances in new materials and microelectronics should quickly kick in.

But now, society must grapple with a fresh conundrum: Where will the money to pay for these miracle devices come from? And how will society determine when it is the right time for the old and the terminally ill to actually die? In the words of Jonathan D. Moreno, director of the University of Virginia's Center for Biomedical Ethics in Charlottesville, "these patients can no longer die a traditional cardiac death."

LONG WAITING LIST? There isn't a lot of time to come up with answers. The Food & Drug Administration has authorized four other major medical centers to implant AbioCor hearts. And even before these experiments get under way, Tools's lease on life could inspire thousands of aging baby boomers to add

their names to the waiting list. Many of the 100,000 people in the U.S. who are candidates for heart transplants might accept an artificial device, and "there is a vastly larger number of patients who could benefit," says surgeon Robert D. Dowling of the University of Louisville, who with Laman A. Gray Jr. performed the seven-hour surgery on Tools at Jewish Hospital.

From one perspective, this huge customer base represents a hair-raising social liability. Surgical and hospital costs for regular heart transplants run as high as \$500,000. These procedures haven't burdened the medical system so far—but only because the supply of transplantable hearts has been limited to about 2,000 a year. Abiomed plans to price its heart between \$75,000 and \$100,000 initially, and with volume production, the price could fall as low as \$10,000. However, even at the lower price, artificial

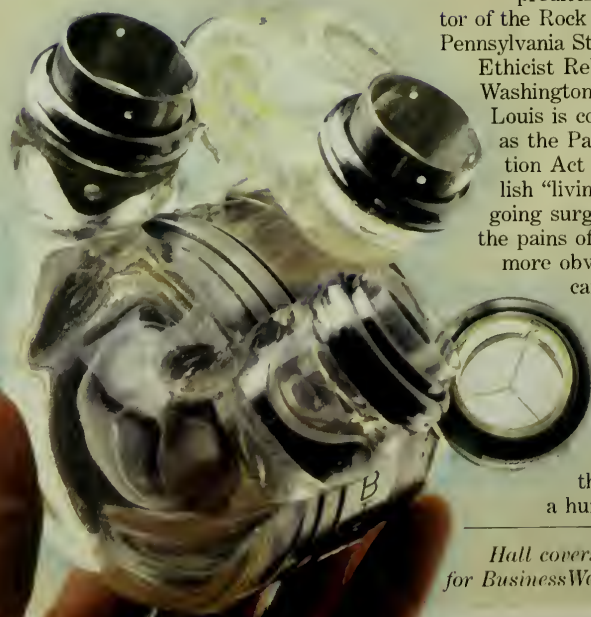
hearts are an issue that will lead into moral quicksands, says medical ethicist David Steinberg of the Lahey Clinic in Burlington, Mass. What happens, Steinberg muses, "if heart replacement—an intervention directly and visibly linked to who will live and who will die—becomes available only to those who can afford it?"

HIT THE SWITCH? On the bright side, devices like the AbioCor could offer a ray of hope to thousands. Tools recently said he was looking forward to going bass fishing with his surgeon, Gray. Multiply such hopes by millions, and heart replacements are a boon, whether the promise is measured in years or just months of enjoyable, productive life.

Still, disturbing questions linger. What will doctors do when the patient's other biological systems signal that it's time to die and the mechanical heart just keeps whirring? Someone will eventually have to hit the switch—be it patient, family, or physician. True, patients on dialysis machines and respirators face such issues daily. But if the AbioCor device becomes common, "physicians and families would be dealing with far more of these cases," predicts Nancy Tuana, director of the Rock Ethics Institute at Pennsylvania State University.

Ethicist Rebecca Dresser at Washington University in St. Louis is counting on laws such as the Patient Self-Determination Act to help people establish "living wills" before undergoing surgery. "Meanwhile, as the pains of perpetuity become more obvious, patients, health-care providers, and legislators will all struggle with the same enigma: It's not just how society will pay for the plethora of artificial organs. It's how we define the new parameters of a human life."

ABIOCOR What happens when the body's other biological systems fail and the new heart whirrs on?



Hall covers science and medicine for BusinessWeek Online.

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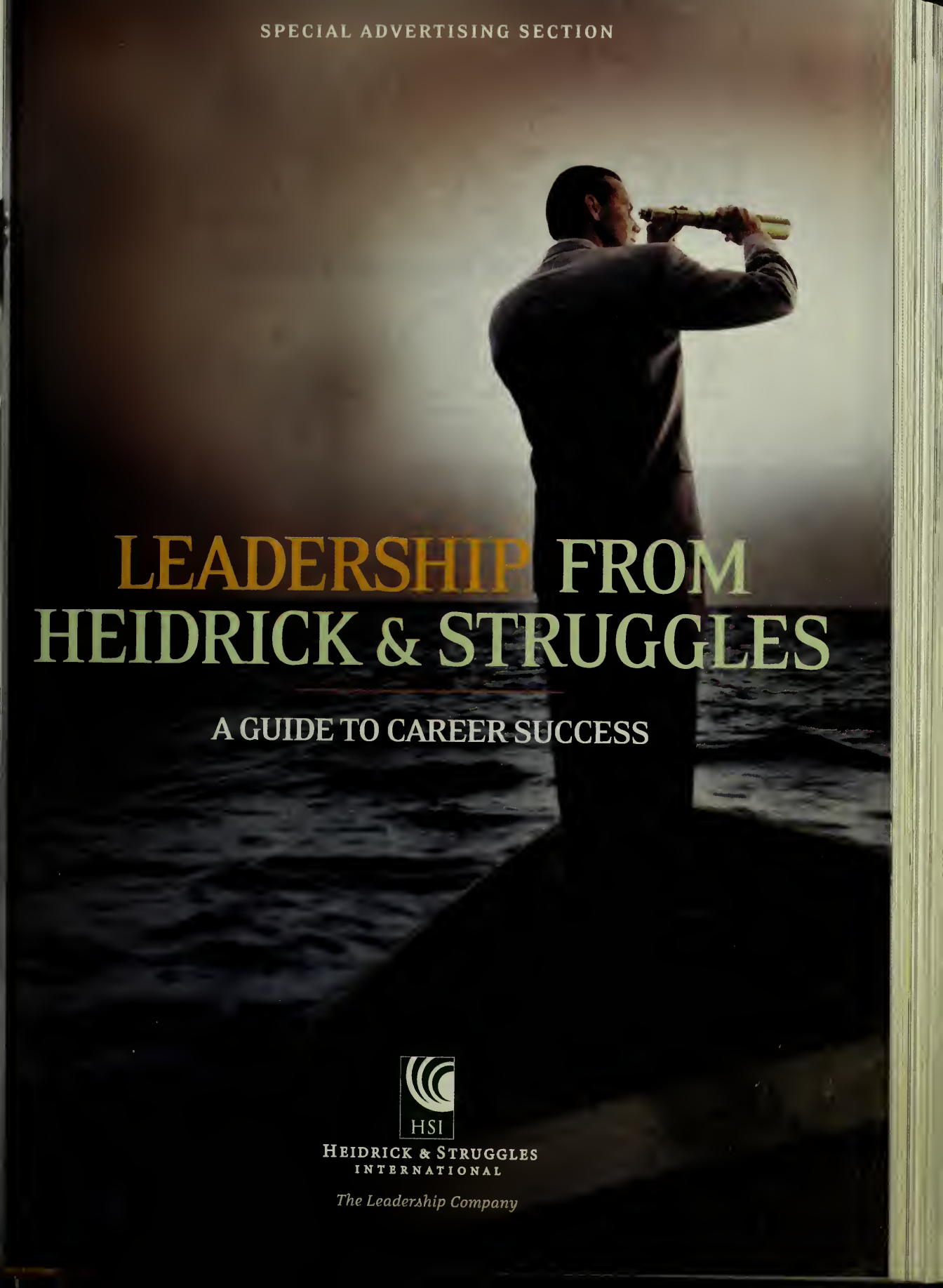
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A man in a dark suit stands on the deck of a ship, looking through binoculars. The background is a hazy, overcast sky and sea. The title text is overlaid on the image.

LEADERSHIP FROM HEIDRICK & STRUGGLES

A GUIDE TO CAREER SUCCESS



HEIDRICK & STRUGGLES
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The Leadership Company

BREAKING ~ TO SENIOR MANAGEMENT ~ THROUGH

BY JACQUELINE MROZ



Beau Vrolyk always knew he wanted to run a company. But the former philosophy major was also wise enough to realize that calling the shots at an organization meant understanding every aspect of the business. So after landing his first job as a software engineer and quickly working his way up to become director of engineering, he did what most accomplished professionals would never consider doing: he left his managerial post to become a salesperson at the same company.

"My whole point was to broaden my experience by doing things outside of my comfort zone" explains Vrolyk, now president and CEO of 3ware Inc., a four-year old data storage company based in Mountain View, Calif. "You need to have a willingness to drastically

change your experience so you can learn new things," Vrolyk says. "Many people find themselves topped out in a company because their experience isn't broad enough."

Gaining valuable experience in a company's various divisions enabled Vrolyk to distinguish himself from his fellow mid-level executives in his climb to the top. But that's just one way to make it to the big leagues of business.

MOVE UP AND THEN GENERALIZE

Gerry Roche, Heidrick & Struggles' senior chairman, who was named "Recruiter of the Century" by a *BusinessWeek* industry survey in 1999, says that mid-level executives looking to move into upper level management should first set their sights on leading a business unit

or division, earn their stripes there, and then make their move.

"My advice to people is move up as fast as you can within one division, and then you will have a better chance to move into a more general, organization-wide role," Roche says.

BE A PEOPLE PERSON

Roche, who has helped place the chief executives of IBM, AT&T, and Home Depot, says that a candidate's people skills are what he really looks at when trying to fill a big executive job. While technical skills and industry knowledge are important, Roche says that people skills can compensate for weaknesses and set a candidate apart from similarly accomplished executives.

"Personal characteristics can make up

for a lack of product knowledge," says Roche. "What did Lou Gerstner know about computers when he came out of Nabisco and we placed him at IBM? But he had what it took to lead IBM."

What does it mean to have people skills? Denise Roistacher, a senior staff development specialist at the Federal Reserve Bank in New York, says excellent people skills mean being able to connect with a diverse workforce to convince them that your vision for the company is the correct one. "You have to learn how to influence people to want change and know how to work with resistance," Roistacher says. "You have to understand different personalities and know how to work with different people."

DON'T NEGLECT COMMUNICATION SKILLS

Learning how to be a good communicator is another important part of being a leader. Rebecca Hefter, vice president of Decker Communications, a New York communications training company, says that having a comfortable and assertive presence as a communicator is critical to getting your big break.

"That means someone who is articulate, who speaks out at meetings in a substantive way, and has good judgment about when a point has been made," explains Hefter. "You don't have to be letter perfect with language, but you have to make a lot of sense."

Hefter, whose company trains corporate executives in the finer points of communicating, says that many of the senior executives she trains work hard on their delivery skills—including non-verbal skills—but, perhaps surprisingly, consider asking questions and listening the most important communication skills. "What makes a leader is knowing when to listen to the people who work for you," Hefter says.

CULTURE CLUB

Understanding the culture—and internal politics—of a company is critical if you plan on cracking the senior management team one day.

"Learning corporate culture is absolutely critical," says Vrolyk of 3ware Inc. "Companies have drastically different cultures, so if you're going to change companies over your career, you have to be savvy about learning the

culture when you make a move."

Kay Kienast, vice president of marketing at Mountain View, Calif.-based SOLID Information Technology, agrees. She says that understanding corporate culture becomes especially important when you need to get things done efficiently and effectively. "You need to know who can help you and whom you can brainstorm with," she says. "If there's an obstacle and you learn how to overcome it, that's what gets you promoted."

One way to obtain a crash course on your company's culture and politics is finding a mentor within the company. A mentor can not only explain your company's corporate culture, but can also help you navigate the inevitable pitfalls. Once you find a mentor, says Roistacher, ask them what they did to succeed.



"What did Lou Gerstner know about computers when he came out of Nabisco and we placed him at IBM? But he had what it took to lead IBM."

—Gerry Roche



Then talk to them about your career goals and how you can achieve them.

Roche agrees that mentors can be helpful, but is cautious about relying on them too much. "Be careful you don't get identified as being protected by Mr. or Mrs. Big," Roche says. "You have to show that you can get things done on your own."

GET YOURSELF NOTICED

No matter what your skills or how many mentors you have in your corner, it's hard to get promoted if you are never in the spotlight. Adiba Khan, a director of marketing at KPMG who worked her way up from an entry level communications coordinator position, says what helped her finally get recognized was a

firm-wide project. That meant interacting with every aspect of KPMG's vast organization, as well as a chance to work with—and impress—partners and directors from different areas within KPMG.

There are many opportunities to cross an organization's boundaries to make a name for yourself. Roistacher suggests volunteering for company-wide task forces, or better yet, offering to lead them. She also recommends calling people in the organization to have lunch or breakfast, and introducing yourself to senior executives at social functions. "It's almost like you're a product and you need to market yourself," Roistacher says.

GO GLOBAL

Kienast, of SOLID Information Technology, believes that working abroad is a major plus if you want a top management position. She managed people in the United Kingdom, Switzerland, and Holland during a three-year stint as director of worldwide marketing.

"It's critical to have international experience," she says. "If you want to be vice president of global marketing, for example, you have to understand how people from different countries buy."

Khan, who volunteered for a three-month stint at KPMG's London office, also found working abroad to be important to her career. "KPMG is a global firm, so it's important that I am able to deal with people from different areas of the world."

Finally, while you're striving for the top, don't forget about trying to find a balance between working hard and spending time with your family. Khan says she often finds it difficult to spend time with her 20-month-old son. The good news is she now feels that if she has worked hard and delivered on a big project, she doesn't have to feel bad about leaving at a decent hour.

If you want to get into senior management, take a good hard look at how much time you want to put into your job, says Roistacher. "That might mean sitting down with your family to see if you have their support," she says. "A new job might mean more responsibility, but more stress and more time away from home travelling. You want to have balance." ■

{ JACQUELINE MROZ is a freelance writer based in Montclair, N.J. }

A LOOK AHEAD AT THE EXECUTIVE

BY MILTON EZRATI

JOB MARKET

Today's rampant economic pessimism is not at all justified, particularly in relation to the executive level job market. To be sure, the rate of economic growth has slowed from the breakneck pace of the late 1990s. 

Profit margins have contracted from their once explosive levels and layoff announcements have become more common, especially in the once dominant technology sector. But by any reasonable standard, today's conditions are actually quite promising.

Let's take a look at the job market. After the recent Internet and dot-com meltdown, things seem pretty bleak to some. After all, the boom gave the able and ambitious a seductive glimpse—albeit a brief one—of quick riches and rapid promotions, even to CEO. But from a longer-term, fundamental perspective, today's relatively low unemployment rate, at 4.5 percent of the work force, speaks to a still robust labor market with plenty of terrific career opportunities.

NO BOOM TIMES

There is, of course, no pretending that these are boom times. The gross domestic product (GDP), the broadest available measure of economic activity, has slowed from a remarkably strong annual growth pace of 5.5 percent one year ago to 1.1 percent so far this year. Other indicators—such as orders and production—have demonstrated erratic, sometimes frightening patterns. But the picture is one of a slowdown, not of the recession that so many fear. Of course, there are risks. As Federal Reserve Board Chairman Alan Greenspan has said on more than one occasion, this economy is not yet out of the woods. So far, however, the economy seems secure on at least a slow growth path.

ECONOMIC ACCELERATION AHEAD

Meanwhile, other signs promise an economic acceleration in the coming months that will bring improvement in corporate profitability as well as an increase in the pace of hiring at all levels.

One of those signs is this year's monetary easing by the Federal Reserve. By driving down short-term interest rates three full percentage points and flooding the economy with financial liquidity, the Federal Reserve so far this year has engineered a major economic stimulus. Few relationships in this economy have as reliable a track record as the link between such monetary easing and an eventual pickup in economic activity. The economy's response is never immediate, of course. It usually takes six months or more to gain momentum, but the impetus for improvement clearly is built into the system.

Meanwhile, the federal tax cuts will reinforce the monetary stimulus. The rebates of \$300 for an individual and \$600 for a couple are hardly meaningful even for the average family, but they will total more than \$38 billion economy-wide, a major cash injection in a concentrated period. If nothing else, the rebates will allow people to pay down credit-card debt and will push back-to-school sales well above expectations.

The strength of the housing market will add to the economic momentum. New home construction is on track in 2001 to produce its second best year ever. Perhaps even more significant, real estate prices

have risen across most of the nation by some 8 or 9 percent from a year ago. This rise not only ensures a continuation of this recent housing strength, but also supports consumer spending by buffering household wealth from the losses suffered in past market declines.

AN IMPROVING JOB MARKET

The job market will reflect the improving economic situation, but only after a time lag. For a few months expect unemployment to rise, moving upwards of 5 percent before moving down again. The job market for professional and management positions should follow.

The unemployment rate in this area presently stands at about 2.2 percent, much lower than the overall rate, of course, but still up from 1.6 percent earlier in the year. It should rise for a while, probably above 2.5 percent. Then the economic recovery will have its favorable effect. As the recovery gains momentum, job growth for professionals and managers should outstrip the available supply of both experienced people and recent graduates. The unemployment rate among this group should then fall to its old lows.

The greatest opportunities will emerge in those areas of the economy with the most fluid environments. Industries like technology, software development, telecommunications, finance, and even retailing are especially likely to see a serious amount of new business formation, as well as dissolution and corporate takeovers. These disruptions will create great risk, but by fostering organizational change and job turnover, they will also broaden prospects at all professional and management levels. ■

MILTON EZRATI is senior economist and strategist for Lord, Abbott & Co., an investment management firm based in Jersey City, N.J.

Throughout my life and career, many people have taken the time to become a mentor to me, ranging from my father to some of the biggest names in business today. What I have come to realize is that if you are receptive to others and observant of what is going on around you, there are endless opportunities in the business world to learn from other people.

I am currently the chief technology officer (CTO) at Encoda Systems, the leading supplier of software and software solutions to the media and entertainment industry. I've held the CTO position at numerous companies, including most recently Time Warner. I was also CTO at Dell Computers, in their online business unit.

FATHER AND MENTOR

My first mentor was my father. A career Army officer with a Ph.D. in history, he retired at the rank of colonel. Ironically enough, he taught me tread lightly when one has authority. It seemed to me that my father possessed a much different command style than many of the other officers. I noticed that he seemed to employ persuasion and influence rather than pure dictatorial authority, while still maintaining discipline. For whatever reason, he was confident enough in himself to do things his own way, counter to the culture he was immersed in. That in itself was a great example that I have carried into the corporate world.

Another important mentor in my life is currently the chief information officer (CIO) of AT Kearney, Michael Johnson. I was the head of technology for Hanna-Barbera Studios when Turner Broadcasting bought the company, and Mike was the CIO at Turner at the time.

In the years that I worked for Mike, he constantly provided me with proactive and constructive mentoring. Some of the key things I learned from him were to judge individuals and groups based on direct experience, not on others' perceptions. Mike also taught me to lead using mostly a macro-management style, freely giving managers more and more responsibility as they warrant it.

A recent mentor has been Carl Dill, former CIO of Time Warner and, prior to that, the CIO at McDonald's for numerous years. What Carl taught me was that any initiative—no matter how complex—can be analyzed, managed, and delegated for ultimate success, if a collaborative culture to

The Art of Being

MENTORED

BY MICHAEL S. DUNN

support the effort exists. He taught me to not get too caught up in artificial corporate boundaries, but instead to partner with all types of people across an organization to achieve common goals.

INDIRECT MENTORS

Two of my indirect mentors have been business leaders I've been lucky enough to observe during their daily activities. While at Turner, I was able to interact with and observe Ted Turner, not as public icon but as a businessman. I found him to be not at all like his public persona of a brash, eccentric maverick. Instead, I worked with a man with an incredible focus on his core business who was amazingly successful at avoiding impediments to his goals. While at Dell Computers, I came to have a great deal of respect for the leadership of Michael Dell. Michael's success story is well chronicled, but witnessing it yourself was something else. Michael created a solid business model, surrounded himself with knowledgeable and trusted experts, and then fostered an ethical, family-focused culture for the entire company. It's that culture that supported and helped Dell succeed at such a frenetic pace and against such odds.

GIVING BACK

Now it is time for me to give back. Today, when I'm mentoring individuals on the teams that I lead, I try to use

I try to emulate each of my mentors in creating a culture that places a high value on team success.

things I've found useful and successful over my career. Using the examples set by Carl Dill and Michael Dell, I try to create an environment that accepts open and collaborative communication, both constructive and creative. Like my father, I try to teach through influence, even though in some cases I have the outright authority to tell someone how to do something. Like Michael Johnson, I try to teach others to obtain first-hand knowledge of a given situation, instead of always relying on the opinions of others. Most of all, I try to emulate each of my mentors in creating a culture that places a high value on team success, which ultimately benefits the overall company. ■

{ MICHAEL S. DUNN is chief technology officer at Encoda Systems. }

TALKING LEADERSHIP with RAY LANE

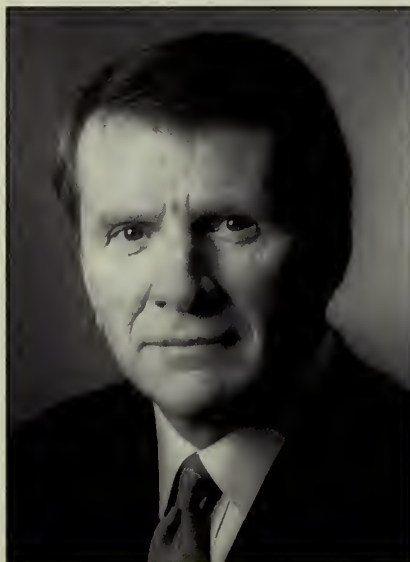
BY MEREDITH D. ASHBY & STEPHEN A. MILES

Ray Lane is the former president and chief operating officer of Oracle Corporation, where he led what some have described as "the transformation of the century." Under his eight years of leadership, Oracle grew into an e-business and consulting powerhouse, seeing a tenfold increase in revenues and an increase of more than 9,600 percent in market capitalization. Today, Oracle is the second largest software company in the world. Consulting and related services account for more than half of the company's \$10 billion business.

Today, Ray Lane is a general partner with venture capital firm Kleiner Perkins Caufield & Byers. Recently, we caught up with him as part of an ongoing series of interviews with the world's foremost chief executives on the topics of leadership and human capital.

Can you describe your current role at Kleiner Perkins Caufield & Byers (KPCB)? How have you been able to draw on your experiences from Oracle, Booz-Allen, IBM, and EDS?

In my role as general partner at KPCB, the responsibility is to raise funds, make investment decisions, sit on boards, and guide companies from start-up through a liquidation event in order to distribute gains to our limited partners. The attraction for me of doing this at this time of my life is that it allows me to remain relevant to technology development for the next great phase of growth for our industry. I've been through the first two phases: the mainframe automation era, and then the



growth of client server applications. I believe that the next era will be about Web services and collaboration between entities in our society over broadband networks. Consumers, brand names, and suppliers will interact in a standard way, much like telephony works today, and the economics of doing business around the globe will change forever.

Being at KPCB puts me in a place where I can see and influence this development, and in fact have a front row seat. Over the past year, I've been able to utilize skills from all my prior experiences. IBM was the best company on the planet for learning sales and the business of computing. Then I went to EDS, where I acquired operational skills by building a large business unit from scratch. Twelve years at Booz-Allen gave me my

MBA and a real perspective from consulting hundreds of businesses and CEOs. I also earned a respect for collecting and analyzing data, and utilizing facts in the decision-making process. I've been able to tap all these skills and diversifications

throughout my career and use them to help the entrepreneurs who come to us today. The whole game here is to invest in good teams and good ideas, and hopefully create wealth for our investors from this.

What is the approach at KPCB for identifying and recruiting executive-level talent for its portfolio companies? What skills and experiences do you look for when building out management teams?

Any CEO I would endorse for a portfolio company has to have team-building skills. They have to know how to recruit and how to motivate people to execute for them. They have to be intensely focused on whatever creates value in that company. Being a CEO is not about managing, it's about producing a direction for a group of people that results in a desired outcome. Understanding the fundamental value that is produced by your company is essential. A CEO has to understand and direct that value into something simple and clear that customers—lots of customers—want to buy. Also, having a proficient skill around the numbers, being very numbers-oriented, having immediate recall of the numbers in their heads, is essential. Do they need the CFO to tell them the revenue, margin, and balance sheet dynamics, or do they understand how the numbers work themselves? This, for me, is the acid test for a good CEO.

Regarding the strategic transformation you led at Oracle, many companies are facing a similar need to transform. What advice would you give CEOs who are contemplating or embarking on a major strategic transformation today?

Trust your gut. In my situation, it was very helpful to me not to know the software business. I understood the basics from an outside perspective, but I had never run a software company. This allowed me to ask basic questions about why we do things the way we do; to question the fundamentals. This is very important. You can only do it once: when you go in. Being new on the scene allows you to ask the fundamental questions, but very quickly you become integrated into the culture and become "one of them." At that point, though, you can't ask those questions any longer, so taking advantage of that nascency to ask those questions is instrumental to a successful turnaround.

The turnaround doesn't happen by just moving a few things around—that's like moving chairs on the Titanic. The little things you can move, you move quickly, but the major transformation happens by going down to the basement and examining the infrastructure and how things are done fundamentally. It took Lou Gerstner, for example, a long time to turn IBM around because it's a huge place. He questioned the foundation, how the place is built from the ground up. So, trust your gut to map out what you think you can do with no boundaries and no restrictions. Then ask the bold questions that people who are typically consumed in the business do not ask. Then execute, making adjustments along the way.

Generally speaking, what has changed in the past 10 years with respect to leadership?

In the past, leadership was done unilaterally. In other words, you sat at the top of an organization where there's a bit of the Ivory Tower mentality, you mapped out strategy, you planned growth through acquisitions or organically, and you basically did this with a small team at the top. It was very hierarchical in nature.

Today, though, it is very much a team effort. Basically, it's a process influencing each person on the team to move in a certain direction. Leadership through influence and ideas is more successful today than the top-down leadership we saw 10 years ago because it's more permanent. People tend to buy-in and embrace the changes as their own, rather than gripe about the direction the boss wants to take.

Secondly, communication has become much more important, especially in large companies where everybody needs a lot of information to keep focused on the mission at hand. Communication from the company's leadership is essential. I underestimated this many times in my career, especially at Oracle, where we went from 8,000 to 45,000 people. Keeping all those people on the same page required a great deal of communication. If you don't continually tell them your vision or your strategy, they make up what they think the company is all about, and if you let that go too long, you end up with a disaster. I also think the need to have a real focus on competitive positioning is a significant change in leadership. If the leadership doesn't have a competitive mindset—how to position products, services, marketing, market share, what your competitor's weaknesses are, and so on—this could be disastrous as well.

*"Today, leadership
is very much
a team effort."*

—Ray Lane



Many of the CEOs we've talked with believe that a fundamental attribute of leadership today is Social Quotient, in other words, the softer skills such as being able to communicate with employees, empathy, and taking others' perspective. This attribute is vital when managing intangible assets, as opposed to the tangible asset management of yesterday's CEO skill set. Would you agree?

Absolutely. The best thing that ever happened to me was not being formally trained as a manager. As I think back over the last 30 years, I left IBM too soon to be trained in its notorious management training program. EDS had no management training at the time I was there. Booz-Allen was a partnership structure. So, when I went into Oracle, I basically relied on my general work ethic, my gut beliefs, my personality, what my mother taught me, and my natural tendency to be a walk-around, hands-on leader. ■

Details of Ray Lane's transformation of Oracle will be featured in a Heidrick & Struggles book on leadership that will be published by Oxford University Press in the spring of 2002.

{ MEREDITH D. ASHBY & STEPHEN A. MILES are business analysts at Heidrick & Struggles International. }



BUILDING THE MOMENTUM FOR CHANGE

BY ELSPETH MURRAY & PETER RICHARDSON

Are you frustrated at your corporation's inability to move more quickly on initiatives that are critical to its future viability and profitability? Have you recently sat in a meeting with your executive team and mused aloud for the 100th time that not enough progress is being made on critical "make-or-break" issues for the organization? In the face of disruptive technologies, increasing customer expectations, new competitors, and ever-greater shareholder expectations, are you trying to change your organization to meet these demands, only to find that it can't happen fast enough?

If you answered yes to any of these questions, you are not alone. For the past 20 years, we have been working with organizations facing the daunting task of effecting major organizational change. Time and again we have heard senior executives make the following types of comments as they discuss change in their corporation:

"We're six months in, and nothing tangible has happened yet."

"Commitments were made but the resources never materialized, and supposedly high priority projects are being starved of necessary resources."

"We don't make the tough calls. We try to accomplish far too much, spread our resources way too thin, and then we wonder why everything moves forward at a snail's pace."

How can some organizations effect change quickly and efficiently, while others stumble right out of the gate

and never catch up?

As you might expect, success is no real secret. The winners, however, combine these ingredients in such a way as to create a self-perpetuating, unstoppable momentum that will keep building until the desired changes become inevitable. Conversely, without enough momentum, change initiatives take too long and, in the worst cases, stall completely.

Physics 101 teaches us that momentum is the product of speed and mass. In terms of today's fast-paced business world, this means that to be successful in undertaking major change, sufficient speed must be generated within the first 100 days, unstoppable momentum within the second 100, and tangible results achieved within six to nine months.

THE FIRST 100 DAYS

The first 100 days after announcing your

change initiative is where the game is either won or lost. These critical early days are all about generating speed. Speed is one of the most critical elements of any corporation's competitive edge. In today's world, corporations don't have 10 years to implement a major strategic change, or even five. Most executives agree that in any major change initiative, substantive results must be realized within the first 12 months.

Most companies, of course, are neither organized nor structured to move at this kind of speed. Here are some ways to jump-start your change initiative to quickly generate speed:

• *Focus on two or three critical, integrated initiatives.* One of the worst mistakes organizations make while undertaking change initiatives is to try and change everything at once. This doesn't work, and never has.

• Create a sense of urgency. Whatever the nature of the change, it is critical for the executive team to take every opportunity to illustrate the importance of steering a new course. There needs to be a major communications exercise that builds awareness and understanding of the need for change. It's unlikely to win everyone over, but as long as a core group of employees—the key influencers—accept the need for change, it will then be possible to build momentum rapidly. This core group forms the nexus of what we call the “human fly-wheel” of change.

• Provide the blueprint. Management must introduce a blueprint that details what the company will look like after the required changes, and explain why that is better than the current situation. Management must then commit to making that blueprint come to life by supporting change efforts across the organization.

• Launch multiple, continuing communications vehicles. Whether via an electronic newsletter, “town hall meetings,” or customized e-mail bulletins, you must create awareness and understanding, reinforce the change initiative, and build commitment.

THE SECOND 100 DAYS

The second 100 days are about generating an unstoppable momentum. Speed alone is insufficient. With speed and insufficient mass, it is easy to stop an object cold in its tracks. Too often, corporate change efforts get diffused throughout the organization, fail to gain critical mass, and then languish, with nothing much happening. To counter this tendency, concentrate initial promotion of the change effort in those areas where it is likely to generate the most enthusiasm. Also:

• Focus a critical mass of resources around each key initiative. Momentum requires that executives be willing to dedicate people and resources to the process, deal with non-performing employees, and eradicate any “sacred cows” hampering change.

• Identify sources of resistance and deal with them. Failure to deal adequately with opposition has derailed more than a few major change efforts. In too many

utives need to spend time promoting and communicating the new direction, incorporating feedback at it comes in.

• Align performance measures and rewards. It is imperative to realign performance measures, recognition, and compensation with the new direction. Initial, more informal recognition and rewards are all well and good, but formal, tangible rewards for innovators and high performers should be put into place as quickly as possible.



The first 100 days are critical to any change initiative.

strategic change initiatives, executives spend far too much time dealing with the impact of the 10 percent of employees who will never believe in change for any reason. Tough decisions have to be made regarding those who don't—or won't—work within the new organization. One CEO we have worked with calls this his “I respect your decision to not come on this journey with us” conversation. Most importantly, however, senior exec-

A SHARED UNDERSTANDING ACROSS THE ORGANIZATION

Speed and mass, while required for a successful change initiative, will not succeed without a shared understanding across the company of both the company's destination and how the journey will unfold. Shared understanding includes:

• A clear statement of the change mission, its objectives and benefits, and the timeframe involved.

• A limited set of clear, unambiguous measures of success that capture the essence of the mission.

• Agreement on the initial three or four ‘make-or-break’ projects or programs that will drive change.

• A set of tactical action plans for initial deployment, with appropriate accountabilities identified.

Achieving these positive conditions for change—generating speed, building momentum, and developing shared understanding—won't guarantee success, but you will have a much

greater chance of being one of those flexible, innovative companies that can change directions very quickly. ■

ELSPETH MURRAY AND PETER RICHARDSON are both professors in the School of Business, Queen's University, Kingston, Ontario. They are co-authors of an upcoming book entitled *Fast Forward: Implementing Rapid Organizational Change* that will be published by Oxford University Press in 2002.

the toughest audience?

BY ROBERT A. WILLIAMS
& REBECCA A. HEFTER

A. Your own senior management

One of the best ways to advance within an organization is to master the art of presentations. Presenting the details of a new operational initiative or the results of the last fiscal quarter to the executive committee of your company is a great opportunity to show your command of the material, your ability to communicate, and your leadership skills.

PAINT A CLEAR PICTURE

Executives at this level are by definition a very tough audience. Their schedules are jam-packed with presentations, briefings, update meetings, and the like. They are dealing with board matters, shareholder concerns, and business challenges that can have a profound effect on the company, the competition, and possibly the marketplace.

Keep in mind that because this is an internal presentation, the audience's impression can have a lasting affect on your career. You need to paint a clear

picture of your main themes, using as few brush strokes as possible.

You also need to tailor your presentation to meet the expectations of a particular audience, something that many presenters fail to do. If the audience is primarily detail-oriented, explain your facts and research before presenting your recommendations or findings. If your audience is primarily focused on the bottom line, it is best to state your recommendations up front and then use your reasoning and facts as support.

THE OPENING

Before starting your presentation, check to see if your allotted amount of time has changed due to previous presentations that might have run long or other changes in the schedule. Be prepared to cut your presentation to meet time constraints. The best method is to have two presentations ready, the original presentation and a much shorter version, about 25 percent of the time allotted.

The extra work up front outlining an abbreviated presentation is also a good idea because you may sense that your audience is restless and interested only in the big picture. If that's the case, you can go straight to the shorter version.

Begin your presentation by establishing the context (a brief reminder of how we got here, i.e., "This is the second meeting to address the issues surrounding...") Then, overview your agenda.

THE BODY OF THE PRESENTATION

The most important point to remember about the content of your presentation is to avoid redundancy. Many presenters—even experienced speakers—get nervous and start repeating themselves. Executives at this level are not likely to remain patient enough to hear a lot of your points twice. The time to restate any points is during the closing.

Waiting for a formal question and answer period is often unrealistic. Encourage interaction at any time and respond to questions as they come up. Each question is a sign the executive is engaged. Difficult questions should be viewed as an opportunity to think through problems and issues.

THE CLOSING

In the closing, briefly recap and restate your point of view, your recommendations, and the benefits of taking your recommended course of action. List the conditions that will lead to successful implementation and positive business results.

You'll know your presentation has been a success when you're still fielding questions well over the allotted time. An even better scenario, of course, is if they accept your recommendations right there and then. ■

{ ROBERT A. WILLIAMS AND REBECCA A. HEFTER are communications consultants with New York-based Decker Communications. }



WHICH DIRECTION SHOULD THE VALUE OF YOUR STOCK OPTIONS MOVE? Up~always up.

BY WAYNE GUAY

Stock options are an integral component of executive pay packages. Some commentators, however, expect this trend to slow or even reverse, given the drubbing many executives took on their options due to recent market declines. My sense is that stock options are here to stay, and that as an executive you should not hesitate at receiving a portion of your salary in options. For one thing, options play a critical role as a corporate governance mechanism. But more important than that, within well-functioning capital markets, stocks should always rise over time.

IRRATIONAL MARKETS? NO.

The past year and a half might seem to disprove that. Many widely held stocks have plummeted, including Cisco, EMC, Lucent, and Oracle, each of which has lost 40 percent or more of its value in 2001. The primary market gauge, the Standard & Poor's 500, fell 10 percent in 2000 and 9 percent more through August 8, 2001. In the last year, the tech-heavy NASDAQ has lost 54 percent of its value. If you've seen a large percentage of the value of your portfolio evaporate into thin air, it is understandable if you now view the markets as irrational. They are not, however.

These declines are a result of systematic market-wide corrections to investors' expectations about firms' future profits. As the run-ups of the late 1990s show, it is possible that over short time periods, investors with rosy views about future profits can bid up stocks to lofty levels. There are strong market forces, however, to correct stock prices when new information reveals that investors have been overly optimistic. Seen in this light, we can now say, for example, that the sharp declines suffered by many unprofitable dot-com start-ups were the outcome of such rational market corrections.



A FAIR RATE OF RETURN

Most of the time, professional investors are very disciplined and rigorous about how they value stocks. They estimate future profits by way of either formal or informal techniques (e.g., analysis of financial statements or a company's capacity to exceed consensus analysts' forecasts, etc.). While it's certainly possible that individual stocks are over- or under-valued, the bottom line is that rational investors systematically price stocks and bonds at levels where they expect to earn a fair rate of return. Don't let the recent severe market corrections scare you away from viewing options as a fair and viable form of compensation.

PRICING A STOCK

Let's take a closer look at how a company's stock is priced. Albertson's Inc., the second largest supermarket chain in the country, currently has 18 analysts

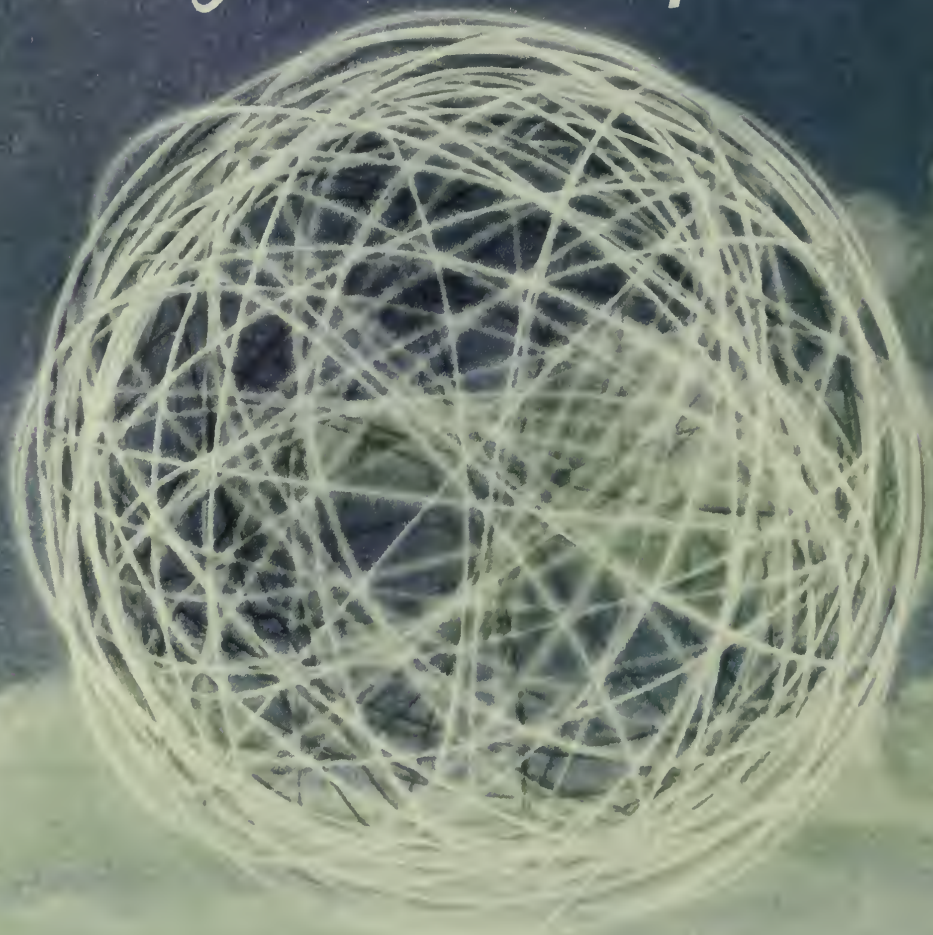
that forecast how much that company will earn in the next year or two. Their forecasts for 2003 earnings range from as little as \$1.78 per share to as much as \$2.70 per share. Investors with high forecasts and high target stock prices end up buying shares and those with low forecasts and low target prices sell shares.

If everything goes exactly as planned, firms generate the expected level of profits and the owners of the shares earn the percentage return embedded in their target stock price. Of course, things often don't go as planned. Business environments invariably change over time, and corporations' profit outlooks invariably turn out different than investors expected. As this occurs, investors re-evaluate their target stock prices. When the profit outlook becomes rosier, investors recognize that they can pay a higher stock price and still earn their demanded percentage return on their investment. When the profit outlook becomes bleaker, investors, who maintain their demand for a certain percentage return, reduce the price they are willing to pay for the stock.

For executives, the key point is that past disappointments in the performance of your stock options should not deter you from accepting new options. The U.S. is home to the most well-functioning capital markets in the world where the most fundamental principles of finance dictate that one should always expect stock prices to rise. If your efforts contribute to the growth and profitability of a public company, and you are patient enough to wait out some market bumps and bruises, both you and your shareholders will be rewarded as the stock price appreciates over time. ■

{ WAYNE GUAY is associate professor of accounting at the Wharton School, University of Pennsylvania. }

when the world is your campus



For Many Busy Executives,
E-Education Is One Way to Get Ahead

BY MICHELE PULLIA TURK

In the two decades Greg Vogt has worked in oil field equipment manufacturing, he has moved up the ranks into management, and today earns a six-figure salary. Vogt, 46, may seem an unlikely MBA candidate. But when his employer, Dover Norris, offered to foot the bill, he viewed it as an opportunity to continue to climb the corporate ladder. Although no promises were made, it was clear that Vogt, a manufacturing and operations manager, was being groomed for the top.

Vogt, who's based in Tulsa, looked into a handful of weekend programs, but opted instead for the University of Tennessee's online Executive MBA program. Vogt and his classmates attend five seven-to-10 day residency periods a year in Knoxville, and they spent two weeks in the emerging economies of Russia and Hungary. The curriculum also requires 17 two-hour instructor-led online classes on Wednesday evenings. "You spend less time traveling, and you don't sacrifice any of the interface with faculty and peers," says Vogt.

LEARN ANYWHERE, ANYTIME

E-learning, the latest trend in continuing education, has meant that thousands of executives like Vogt have signed up for classes in cyberspace to sharpen their skills or earn advanced degrees. Besides, when the economy cools down, competition for jobs—even within companies—heats up. In recent months, the shaky economy has fueled added interest in some EMBA programs, which unlike a traditional MBA, tailor assignments to students' companies, industries, and jobs. "They're looking to enhance their capabilities, broaden themselves and make themselves more valuable," says Maury Kalnitz, executive director of the Executive MBA Council, which represents 150 member schools. "In a shrinking economy, it's the person that has the most to offer that companies retain."

With a laptop and phone line, students can log onto e-learning classes anywhere in the world. "Online universities offer busy people a flexible, convenient way to continue learning and achieving," says Daryl Capuano, an e-learning analyst with Brandon-hall.com. "Employees can learn as their lifestyle, schedule, and needs dictate."

GOOD FOR THE COMPANY, TOO

In fact, research has shown that e-learning programs can be effectively

delivered in roughly half the time of a traditional classroom, says Chris Reed, vice president of corporate strategy for Centra, an e-learning software and services provider. "You can transfer knowledge much more rapidly to a much more broad audience," he says. "It's the next frontier in competitive advantage."

The savings are enormous for corporations concerned about the bottom line who have embraced e-learning to educate employees in the past few years. The percentage of organizations using the Internet for training purposes grew from 3 percent in 1996 to 38 percent in 1999, according to the American Society for Training and Development

"You spend less time traveling, and you don't sacrifice any of the interface with faculty and peers."

—Greg Vogt

(ASTD). "Companies save on travel expenses, non-productive time out of the office, and the expense and inconvenience of getting the instructors and students in the same place," says Capuano.

While some start-ups with inadequate funding have already gone under, the e-learning industry seems to be weathering the dot-com crash. It's estimated that the U.S. e-learning market will grow to approximately \$10 billion by 2003.

Many traditional universities have expanded into e-learning, pioneering innovative online programs. For example, students enrolled in Duke's Global EMBA program travel for 11 weeks to Europe, South America and Asia; they complete the rest of the curriculum via the Internet. Start-up online universities are also catching on. Cardean University, established by Unext.com, provides continuing education classes and degree programs by teaming up with institutions like Columbia Business School, the University of Chicago, and the London School of Economics.

But taking academic classes and getting degrees are not the only goals of

continuing education students. Barnes and Noble University offers free classes in business etiquette, building a Web site, estate planning and online investing. Or just for kicks, students can sign up for Jazz History, Feng Shui, Golf Basics or Herbal Medicine. Likewise, corporations aren't just using e-learning to update the computer skills of crusty old-timers. Dozens of companies produce online sexual harassment prevention materials, and attendance is required at some companies.

BLENDED LEARNING

Many e-colleges require some on-site classroom attendance, but others, such as the University of Phoenix, allow students to earn degrees—even MBAs—entirely via the Internet. Founded in 1989 for adult professionals, the school now has 25,000 students enrolled in online programs. The University of Phoenix uses what's known as an asynchronous format: assignments are posted on the Web site and students can attend class at their own pace, even at 2 a.m. in their pajamas. Recently, however, as the technology has been improved, synchronous—or live—e-learning has been gaining converts with its real-time interaction, two-way audio and data, and potential for customizing the e-learning experience. "The most effective learning experiences," says Reed, "are a mixture of different approaches, e-learning and traditional strategies."

Of course, there are critics. All distance education programs aren't reputable and a degree from an online university still may be viewed as second-rate in terms of prestige.

With all its advantages, e-learning cannot replicate the dynamism of the campus experience. "Human energy," says Capuano, "in the form of that rare inspiring teacher or vibrant seminar, cannot be matched."

Yet for the most part, e-learning holds its own against traditional learning in terms of class size, discussions and participation, faculty expertise, and the ability to apply what students learn to the real world. "E-learning classes provide an education that even skeptical academics have acknowledged as high quality," Capuano says. ■

{ MICHELE PULLIA TURK is a freelance writer specializing in lifestyle issues. }

JOHN THOMPSON'S PERSPECTIVE ON

Leadership and The Talent Landscape


 BY MEREDITH D. ASHBY & STEPHEN A. MILES

John T. Thompson, vice chairman at Heidrick and Struggles, is widely recognized as one of the leading CEO recruiters in the country. He has conducted several hundred CEO searches over the past 15 years for start-ups, mid-cap companies, and multinational organizations across a broad spectrum of industries. Best-known for his work in the technology sector, Thompson has been recognized as one of America's most respected executive search consultants, as featured in the book, *Career Makers: North America's Top Executive Recruiters*. We sat down with John recently to get his perspective on today's recruiting environment.

Can you give us an overview of the labor market for senior-level executives? Is there a war for talent, and in particular, for leadership talent?

There is a huge shortage of highly talented people having domain experience in relevant industry segments or with relevant business models but, in particular, there is a dearth of general management, i.e., leadership, skills. By leadership, I refer to the skills needed to succeed in today's environment, such as the ability to energize a group of people to take on an objective. In turnaround situations, it is the ability to take a company forward in terms of scale and scope. With all the mergers and acquisitions we've seen lately—which all look great in the short-term but are being tested now in a tougher economic climate—leadership is the ability to come into a company and make cultures fit and work. Leadership is a rare asset that, on a statistical basis, only a handful of people have. To really energize a company in turnarounds; to mend broken cultures; to create long-term success out of mergers and acquisitions; to lead companies that are in the tank financially or are in a real growth mode but don't have the right management team; these are all leadership skills that are often missing from the talent pool. And, of course, there are many companies today in need of an injection of new leadership.

What are the challenges in recruiting people who have made transitions between legacy companies and non-traditional companies?

Consider that a huge percentage of people took risks during the "irrational exuberance" over the Internet and were damaged emotionally, financially, or both by the whole experience. Their risk profiles are now quite different as a result. At one time, it was relatively easy to go into a small, high-growth company and build wealth. Now, however, as investors view business models with a judicious eye and valuations have become much more sensible, candidates have adjusted and are more risk averse. Another reality is that many of today's younger executives have never been through turbulent business cycles, and certainly not through a recessionary environment. I call these executives "upside managers," because they have really only managed in an upside environment and as a result are somewhat unproven as managers. Even companies that have done well over the past year or so may have a management team that cannot lead through a tough economic climate, or cannot lead the organization to the next level. Executives in their 30s and early 40s have not managed through a tough economic period, so deficiencies are magnified. At the senior level, they are magnified even more. We have to consider this as we look for talent now.

How comfortable are Boards and hiring managers with going outside an industry, or even outside the typical functional area, to recruit a candidate? For example, your placement of Ray Lane at Oracle brought an understanding of the complexity and potential of the consulting and services industry to a high-growth, software product environment. How comfortable are companies with unconventional candidates?

In Ray's case, he was head of information technology for Booz-Allen and probably in line for its next president before we recruited him to Oracle. It's a real compliment to [Oracle's CEO and founder] Larry Ellison that he felt the need for change at the time, and that he and his Board were open to considering a candidate who possessed all the skills to be an effective change leader but had no direct industry experience. The risk with Ray was that despite being viewed as a superstar within the consulting industry, he had never been responsible for a single dollar of software license revenue. He had never had to deliver quarterly numbers and had never sold a software package, but we believed he could build a services business over time that would ultimately prosper.

Very often, the best candidate is not a slam dunk choice, not an obvious choice. With almost every search, the search committee says it wants to look at unconventional candidates, but there's inertia not to, for various reasons: because of fear of what The Street will think, fear of what customers will think, the time it would take to get up to speed, and whether there is enough team support during the initial learning curve. There

can be a huge payoff for Boards bold enough to look at unconventional candidates—people with the core leadership skills, including the soft assets we've mentioned.

It seems that you are as much a talent manager as you are a recruiter. You know the talent, you understand the talent, and when the right opportunity comes along, you match the talent with that opportunity. What is your approach to recruiting and evaluating talent?

Ironically, we try not to have to "search" for candidates; the idea is that we already know them and their limitations, their strengths, their goals, both personally and professionally. I typically see up to six candidates a week who have nothing to do with any specific search assignment I'm on at the time. My staff is focused on getting people in front of me who are delivering results, showing exceptional leadership in tough times, or continuing leadership in good times and are not mere-

ly flashes in the pan. I like to meet those people and after a brief introduction, I ask every one of them the same series of questions. They range from, "What do you have in mind for yourself? What is important to you? What is your managerial philosophy? What motivates you? What is your tolerance for risk, or your appetite for a challenge?" to "Tell me about your family. Does your spouse work? What are the ages of your kids? Are there any special issues such as learning problems they may have? What are their interests? How often do you spend time with them? What kind of support sys-

tem do you need around you for success?"

I look for balance, because people who don't have balance are great candidates for burnout. They may be terrific sprinters, but they won't be around for the end of the marathon. By understanding peoples' value systems, I get a sense of what they'll have fun at, what they think they are good at, and when it would make sense to call them on a certain opportunity.

We get people to the table that a lot of other firms cannot because we are very serious about recognizing and matching opportunities with people and then going to them to talk about it. This is our charter: to provide confidence that there is an excellent career fit. It is rewarding for clients because if they concur with our assessment on a candidate, then this person is worth taking the risk. I believe one should be bold, take the heat on the front end on your choice, be passionate about your decision, and you will not be sorry. There are only two questions for finalist candidates: "Do you think you can do this job?" and, if the answer is yes, "Do you want to do this job?" If the second answer is yes, you have the potential for an exceptional fit and the beginning of a real success story. ■

{ MEREDITH D. ASHBY and STEPHEN A. MILES are business analysts at Heidrick and Struggles International. }

"I look for balance, because people who don't have balance are great candidates for burnout. They may be terrific sprinters, but they won't be around for the end of the marathon."

—John Thompson

IS ENGLISH ENOUGH?

Foreign Language Skills Can Open Doors

BY CHRIS SULAVIK

As more and more American companies compete globally for opportunities, now is the time to consider foreign language skills as powerful business tools that can give you a considerable competitive edge in furthering your career.

IT'S ALL ABOUT CREDIBILITY

True, English has become the lingua franca of global business. If this is the case, then why put in the grunt work of learning a foreign language?

To Nick Oakley, vice president at a large recruiting firm in London, "it's all about credibility and building personal as well as business relationships. It's a reality that if you know English, you don't really need to learn a foreign language, but it undeniably gives you a personal and professional edge," says Oakley. "It doesn't really matter which additional language you speak, it's just important that you learn a language to show initiative. It tells people you are interested in a better form of communication."

Oakley also stresses that greater credibility can only lead to greater business success. "I think you'll find more business opportunities and have a competitive edge if you know the language your foreign counterpart speaks," he says. "There are a lot of people who speak English, but would rather speak their mother tongue, which takes them to a greater comfort level, especially when discussing sensitive or discreet information."

WHICH LANGUAGES ARE THE RISING STARS?

For American executives, Spanish is becoming the second language of choice, according to Mauricio Castro, director of Berlitz's Language Center at the company's headquarters in Princeton, N.J. "Spanish is huge. With some 35 million Spanish-speaking Americans, U.S. businesses are increasingly keen on reaching that growing market through advertising and doing business in Spanish," says Castro. Castro adds that next on the list is German, with student enrollments surging since the reunification of Germany and subsequent opening of increased business opportunities there.

Japanese remains consistently popular for American executives doing business in Asia, along with Cantonese and Mandarin Chinese, which are slowly gaining in popularity among business people, according to Castro. "American business executives have woken up to the need of learning a foreign language," Castro says. "It allows them to build business relationships and makes them more confident."

THE RIGHT APPROACH

There are a number of effective approaches to learning a language. For most time-stretched professionals, enrolling in a semester-long course at the local university or spending a few weeks abroad at a language school is untenable. Common solutions include

weekend or week-long immersion courses, private tutors who come into the office or home, computer software programs and books, tapes that can be played during a commute, and e-learning Web sites that offer self-paced or real-time chats and instruction. Keep in mind that it is not unusual for companies to pay for language instruction, especially if an employee is likely to be posted abroad.

Overall, immersion courses tend to be the most effective. Castro said that Berlitz's four-week immersion course (40 hours of instruction each week) is popular among business people who need a crash course before being posted abroad. He recently had a professional couple in their thirties moving to Tokyo. They took the four-week course which "gave them the survival skills that will help them both socially and professionally," Castro says, adding, "even if they don't speak perfectly, they're at least trying, and that means a lot to people in other countries."

Whatever the method, remember that the best way to improve your skills with the language is to interact with as many native speakers as possible. Try not to use gadgets like handheld electronic translators and automatic computer-driven translation, crutches that will only serve as obstacles to really learning the language. ■

{ CHRIS SULAVIK is a freelance writer living in London. }



Heidrick & Struggles International, Inc. is the world's premier provider of management and executive-level search and leadership consulting services. More than 1,000 Heidrick & Struggles professionals operate from offices in over 75 locations throughout North and South America, Europe, the Middle East, Africa, and Asia. For nearly 50 years Heidrick & Struggles has specialized in building the finest leadership teams for companies around the globe.

EDITORIAL DIRECTION: Mike Brewster
DESIGN: Segal Savad, NYC



PhD DROPOUTS
Brin and Page
left Stanford
together to
found Google
in August, 1998

cording to Jupiter Media Metrix Inc. With the company handling 120 million Web searches every day, Google's traffic has leaped 73% so far this year, making it the top pure

search site on the Web.

More impressive, Google has found a way to make those eyeballs pay off. Analysts estimate the upstart's revenues this year will be a not-too-shabby \$50 million. Its business is split evenly between advertising on the Web site—a business that has been growing at more than 10% per quarter—and selling its search technology to other sites. Google claims that, after two quarters of being cash-flow positive, it will turn a profit when the third quarter closes at month's end. "Google could feasibly be a billion-dollar business [someday]," says Safa Rashtchy, a senior analyst at U.S. Bancorp Piper Jaffray. "It's a matter of continuously advancing its technology edge and finding ways to make that pay."

HOISTING. Google is in the process of transforming itself into a tightly managed company that could attempt an initial public offering in the coming year. In August, the board brought in Chief Executive Eric E. Schmidt, the former CEO of Novell Inc., to try to hoist Google to the next level. His mission: to capitalize on Google's search technology by entering new markets.

The next stage of growth won't be as easy as the early days. Google is trying to expand into markets that are established and hotly contested, such as selling its search technology to corporations for use on their in-house networks. And Schmidt, while lauded for his technical expertise, has been criticized for ineffectual leadership at Novell. That company's share of the market for network operating systems fell from 15% to 11% during his four-year tenure, which ended when he resigned in July. "There was no one at the helm," says one former Novell exec. Schmidt admits his performance was "mixed," but he says Novell's fortunes sagged when he couldn't diversify fast enough.

It looks as if Schmidt has picked a winner this time. Google has a strong chance to thrive, thanks to its core strengths. His easiest task is widening Google's technology lead—the startup's bread and butter. In late 1995, Google co-founders Sergey Brin and Larry Page began working on its technology when

THE INTERNET

WHY THEY'RE AGOG OVER GOOGLE

An IPO may loom for the search engine everyone loves

In the aftermath of the terrorist attacks on New York and Washington on Sept. 11, popular news Web sites such as CNN.com and ABCNEWS.com were overwhelmed with a deluge of people grasping for the latest information. For many, the sites were inaccessible. Into the breach stepped Google Inc., the search engine company. It had made copies of the news pages before the crush and offered them up on its site. Those events were obviously excep-

tional, but they illustrate the role that Google has come to play. For many Web surfers, it's the vital intermediary between what they want to know and the answers that are out there somewhere on the vast Net.

Google's rise has been remarkable. In just three years, despite spending nothing on marketing, its search engine has become the 15th-most-visited Web site in the U.S., ac-

Google™



Nice facade. Bad infrastructure.

INFRASTRUCTURE: SOONER OR LATER, IT MATTERS.

INFRASTRUCTURE. The physical foundation of any thriving enterprise. In the world of technology, infrastructure means integrating the servers, software and storage systems of an e-business into one finely tuned and solidly reinforced machine.

To put it simply: as goes infrastructure, so goes the enterprise. All the ingenious products, brilliant marketing and champion deal closers won't amount to much if your supply chain is buggy, the network crashes or the databases fail (and all you have to say is, "Sorry, but the computers are down; can you call us back tomorrow?").

Infrastructure is about hard questions: What platforms should I use? How do I plan for the unexpected? Will it grow when we grow? Will it work with new technology in the future? Will it build upon my current systems? Can I link it to my customers' and suppliers' systems? I've heard all about open

standards, but what exactly can they do for my business? What about outsourcing? And how am I going to finance all of this?

The people of IBM, together with our Business Partners, help literally thousands of companies with questions like these every day. And then solve them with open, flexible technologies, like Linux-enabled servers and storage systems that scale on a simple, pay-as-you-grow basis. And using innovative IBM software tools like Tivoli®, DB2® and WebSphere®, IBM specialists are helping real businesses everywhere build solid, flexible infrastructures.

So, unless you can turn your botched infrastructure attempts into fabulously profitable tourist attractions, give us a call at 800 426 7080 (ask for infrastructure) or visit ibm.com/e-business for our latest white paper on e-business infrastructure.

The sooner, of course, the better.





CEO SCHMIDT

The ex-chief of Novell is expected to bring maturity to Google's free-wheeling culture

instance, now searches more than 1.6 billion Web pages, up 60% from a year ago. That, however, is only about one-third of the estimated 5 billion searchable Web pages, according to Internet search company Cyveillance. To extend its reach, Google has expanded the number of languages it can deal with. With the addition of Arabic and Hebrew, Google now spits out results in 66 languages. By comparison, rival AltaVista Co. performs searches in only 25. Google also is working on technology to search a wider variety of documents, including images, which will be rolled out in the next couple of months.

With all this in hand, Google is starting to pound on the doors of corporate customers. Marthastewart.com, for instance, pays Google to "crawl" its Web site, organize and store the data, and then return search results when a user searches for, say, wedding gifts. So far, Google has announced only seven corpo-

they were PhD candidates in computer science at Stanford University. The two dropped out and founded Google in August, 1998. Not only does Google's technology look for keywords inside of Web pages, but it also gauges the importance of a search result based on the number and popularity of other sites that link to the page. This summer, a survey by market researcher NPD Group ranked Google the most effective search engine, with 97% of users saying they located what they were looking for "every time" or "most of the time."

How can Google get better? It's planning to cast a wider net to capture more of the Web's ever-expanding ocean of content. The company's software, for

rate customers, including Cisco System Inc. and Procter & Gamble Co. That's paltry list compared to rival Inktomi with 2,500 customers, and AltaVista with 1,000. "It's going to be a load on [Google] to move in this direction," says David C. Peterschmidt, CEO of Inktomi Corp.

WIDE WORLD. Google also aims to expand on its successful start in Net advertising. Unlike portals such as Yahoo Inc. and CNET, Google has seen online ad sales rise in recent quarters. The reason? The ads on Google's site are delivered as a text listing above the search results—making them appear more a part of the page's content. "It works so well since users seem to be under the impression that all ads are graphical in nature and written-word ad placements are still editorial," says ad buyer Jonathan Adams, senior partner at Ogilvy Interactive.

Now, Google is attempting to duplicate this success overseas. More than half of Google's traffic comes from outside the U.S., yet it hasn't scratched its potential with international advertisers. Schmidt's answer: Build a network of foreign offices that can forge relationships with local advertisers. In recent weeks, Google has opened offices in Britain and Japan. Germany is next.

Google is growing up. A successful IPO would be the surest sign yet it has gone from an Internet sensation to a real business.

*By Ben Elgin and Jim Kerstetter
Mountain View, Calif., with Linda Himmelstein in San Mateo, Calif.*

GOOGLE'S GAME PLAN

Google is the Net's leading provider of consumer search technology. In August, Google brought in former Novell CEO Eric Schmidt to lead the company. Here are his recommendations:

CHALLENGE

KEEP INNOVATING Google's technology tops that of rivals because it rates Web links by their relevance rather than just searching text. Now, it must stay ahead of the pack.

SOLUTION

SEARCH MORE OF THE WEB Google is developing technology so that search queries will be more accurate. It's adding images and new documents to expand its database.

PROSPECTS

EXCELLENT Half of Google's 230 employees are engineers, many of whom have PhDs in computer science. In short, it has the brainpower and the plan to stay on top.

PUMP UP AD REVENUES Ad sales make up 50% of Google's revenues. Despite a 10% increase in ad sales every quarter since its inception, only a sliver comes from foreign companies.

GO GLOBAL Google needs more feet on the street outside the U.S. It has recently opened sales offices in Britain and Japan, with one in Germany expected by yearend.

FAIR Google is playing catch-up to Web giants such as Yahoo!, which has 25 country-specific Web sites and pulls in 18% of its revenues from international ads. New offices are costly.

FIND NEW CUSTOMERS Google's technology powers the search engines of more than 100 portals, including Yahoo. But the company has only seven corporate customers.

CRACK CORPORATIONS Google believes it can use its brand name and know-how to break into more businesses. It's also counting on Schmidt's Rolodex to help get in the door.

POOR It will be difficult for Google to edge out entrenched rivals such as Inktomi and AltaVista, which have 2,500 and 1,000 corporate customers respectively.

COUNT THE BEANS BETTER Google is preparing to go public next year, but it must first put in place financial managers and processes that resonate with Wall Street.

HIRE A CFO Schmidt replaced a small-business accounting package with heavy-duty financial software. Now, he needs a chief financial officer who can build rapport with analysts.

GOOD Google has the brand name and two quarters of operating profits that could lure a high-profile CFO. Investment bankers are already clamoring for a piece of its IPO.



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COMMENTARY

By Robert D. Hof

DESPERATELY SEEKING SEARCH TECHNOLOGY

After e-mail, people spend the most time online searching for stuff. Whether they're seeking information, entertainment, people, or products to buy, their first click after landing at a Web site is usually the search button. An easily searchable online catalog is what started Amazon.com Inc. on the road to stardom. EBay Inc. would still be an amusing online garage sale if its front-and-center search engine could not zero in on that one rare Disney movie storyboard. But all too many Web sites have ignored those lessons, relegating their search buttons to tiny boxes on the bottom of the page and not keeping up with the latest search technology.

That's a huge mistake—and many e-commerce companies are paying the price. Even as they struggle to attract and keep customers, sites that ignore the importance of search are losing sales without ever realizing it. Market researcher Jupiter Media Metrix Inc. found that 80% of online users will abandon a site if the search function doesn't work well. Says Martha M. Frey, an analyst at market researcher Patricia Seybold Group: "You could make a case that the main reason e-commerce is unprofitable is that the power of search has been overlooked."

BID UP. At the same time, a good search capability can help turn that situation around. Another market watcher, Forrester Research Inc., notes that more than half of online buyers use search to find products—and the better the search tools, the more they buy. That's what eBay, where buyers and sellers make an average of 30 million searches a day, has found whenever it has improved its search feature. "Every time we added a capability on search, bidding went way up," says Maynard Webb, president of eBay's technology unit.

The thing is, any e-commerce site

can get the same results if it makes the effort. Search technology is continuing to improve at a fairly rapid clip, offering more accurate results. Google Inc., for instance, has become the Web surfers' search engine of choice (page 83). That's thanks to software that tallies the number of links to pages containing the chosen keywords, returning remarkably useful results.

And this is not the end of search innovation. EBay chose Fast Search & Transfer, based in Norway, for its new search technology because it delivers ultrafast updates of the latest auction postings and bids. Others, such as EasyAsk Inc.'s search engine used on Landsend.com, don't use just

find it. There's no search button to be found anywhere on the Body Shop's site, only fuzzy categories such as "Make Over" and "Wellbeing." Smarter sites such as Ritz Interactive's camera site, for instance, place a prominent search button not only on the home page but also on every single page, so shoppers can always go directly where they want.

SERENDIPITY. It's equally important to avoid designing search capabilities that take things too literally. All too often, misspellings bring up zero results. Web sites can program their search engines to respond to common misspellings. And search shouldn't always be too surgical. Amazon.com offers a sense of serendipity. When a search for John Grisham's latest book, *A Painted House*, lands on that page, shoppers also see a list of other products that people who purchased the book have bought, in case they might interest the shopper.

Most challenging, e-commerce sites must open up their private product databases to public search engines. That way, shoppers can find their products without having to know the Web site address. But the company's techies must be more open than they're used to being. "There is a lot of concern about what they consider proprietary data," says Google Chief Executive Eric E. Schmidt.

Not all of these improvements are easy to achieve. They often require rebuilding the site and rewriting entire databases to keep search in mind. That cost is tough to justify when it's so difficult to peg increased customer purchases on a site to search improvements. But unless e-commerce companies wise up and make the extra effort, even more of their employees will need to search for something else: new jobs.

Senior Writer Hof covers e-commerce.



"The main reason e-commerce is unprofitable is that the power of search has been overlooked"

keywords to find stuff. Instead, they search an underlying database to get at what people might want. When shoppers search for "green shirts," they get a broader list that allows them to choose among "forest" or "heather."

Much of the improvement can come from simpler means: playing up the search function and designing the site to take advantage of it. One thing that should be dead obvious but clearly isn't: The search box shouldn't require a search engine to



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COMPUTERS

DELL, THE CONQUEROR

Now the king of cutthroat pricing is looking beyond PCs

Last spring, after listening to Dell Computer founder Michael S. Dell speak at length about the future of technology, a young business student stood up to ask a question: If Michael Dell were back at the University of Texas where he started his company from a dorm room in 1984, what kind of company would he start today? "Well," Dell said bluntly, "it wouldn't be a PC company."

Especially if he had to tangle with the likes of Dell. Since the 19-year-old college dropout hit the computer scene, he has been shaking things up by taking efficiency to new highs, squeezing every last centavo out of the cost of building and selling PCs. For 17 years, rivals have struggled to keep up. Now, it looks as if they have lost the fight. Dell, the undisputed low-cost leader, declared a brutal price war a year ago just as the industry slipped into its worst slump ever. The result has been nothing short of a rout. While Dell has chalked up \$361 million in profits this year, the rest of the industry has logged \$1.1 billion in losses. Rivals Gateway Inc. and eMachines Inc. are on the ropes. And with its Labor Day decision to be purchased by Hewlett-Packard Co., even longtime PC king Compaq Computer Corp. has cried uncle. "When we sell these products, we make money. When our competitors sell them, they lose money," crowns Michael Dell.

Trouble is, Dell's recent success is the

result of a dangerous game. Sure, Dell is now the world's No. 1 PC maker, vaulting from 10% of the market in 1999 to 13% in July, powering it past Compaq for the lead. But to make its market share gains



RISKY? Dell slashed server prices

so staggeringly fast, Dell depth-charged prices, dropping gross margins from 21.3% in October to 17.5% in July. Only by laying off 5,000 people has the company stayed solidly in the black. And that's bound to get harder to do. With PC revenues pegged to fall 10.8% this year—the first annual drop ever—price wars are expected to take profits even lower. Not even a rebound promises relief. His-

tory has shown that PC makers don't hike prices on buyers who have grown accustomed to ever-cheaper technology. "If margins do come back, it would be an industry first," says a top Dell executive who recently left. "If they don't, there has got to be a Plan B."

"FAITH AND HOPE." Dell insists Plan A is giving him A-plus results, so why switch? In the coming months he aims to do even more of the same: push his low-cost approach harder than ever in PCs, while applying the same tactics to markets with juicier margins: computer servers, storage, and networking. His bet is that software giant Microsoft Corp. and chipmaker Intel Corp. will continue to invest heavily in technology advances. He can then buy their sophisticated software and chips to sell ever more powerful gear with ever fatter margins. Once he gets a foothold, he'll start lowering prices, deflating rivals' profits, and stealing their customers. "Every single time Dell targets a new market, the naysayers say it's too high-end," says Joel J. Kocher, Dell's former No. 2, who now runs Web-site manager Interland Inc. "Look at what has happened. The technology shows signs of commoditization, Dell lightning strikes."

Only this time, if Dell continues

'I'M GOING FULL BLAST'

1984 In a university dorm room, Michael Dell hits on a revolutionary idea: Sell PCs over the phone, rather than build a costly sales team or pay a middleman a distribution fee.

1988 With great prices and quick delivery, Dell's sales hit \$159 million. The efficient model enables 30% gross margins, making it easy for Dell to undercut rivals who enjoy 40%-plus margins. Dell goes public, raising \$30 million.

1991 Compaq and IBM move to squelch the upstart—or so they think. By creating new units with pared-down staffing and R&D, they narrowed Dell's gross margins lead. It isn't enough.

1993 Dell launches a price war against Texas rival Compaq, calling its laptop price "the lap of lunacy." Dell predicts its 4.1% U.S. market share will hit 18%. It sounds audacious, but they did it in 1999.



DANGEROUS GAME

Michael Dell's low-cost tactic worked in boom times. But now margins are slipping fast

First Boston analyst Kevin McCarthy thinks Dell will need to catapult from 13% to 23% worldwide share in two years just to keep profits flat. McCarthy says Dell can do it, but that's fast even by Dell standards. In 1993, when Dell predicted his company would jump from 4% to 18% of the U.S. market, it took six years. This time Dell will be up against big players like IBM and HP, who are desperate to remain full-line computer providers. But hike market share he must—especially if the price war continues at this pace. Should that happen, Dell's operating margins could fall to 5.5% from 7% over the next two years. And PC sales are expected to grow just 8% annually over that time, hitting 144 million units in 2003. For Dell to manage \$2.6 billion in profits—a smidge more than it posted in its 2001 fiscal year, ended Feb. 2—it would need 23% of the market.

SLIM R&D. Sound like an impossible task? Not to Michael Dell. Supremely confident in his efficiency machine, he thinks he can do even better. He says Dell can reach 40% market share, although he won't say by when. And he seems to think he can do it without making a major acquisition. Indeed, sources say Dell was approached about whether it was interested in buying Compaq, but

no serious talks ensued. Both Dell and Compaq CEO Michael D. Capellas declined to comment.

If Dell can make such massive gains, the chance of any innovation by PC makers may fade for good. A Dell with 40% market share in, say 2005, would be a \$100 billion-plus behemoth with huge influence over suppliers and rivals. Add in its bare bones spending on research and development—a measly 1.5% of revenues—and no rival is likely to risk

price-savaging indefinitely, investors could be the ones zapped. That's because Dell's model works best in boom times, when huge volumes can make up for shrinking profit margins. But with the long-term forecast calling for slower PC growth, Dell will have a harder time keeping its bottom line afloat. That has some investors rethinking Dell's earnings potential. Chris Faber, a portfolio manager with investment firm Cash Flow Return on Investment Global Ad-

visors, figures the cash generated by Dell's existing businesses over the next 10 years will be \$17.7 billion. Divide that by Dell's outstanding shares, and you get just \$6.80 per share—far from Dell's current \$22.57 stock price. What's holding up the other \$15.77? "Faith and hope" that Dell will find its way out of this PC-profits trap, says Faber.

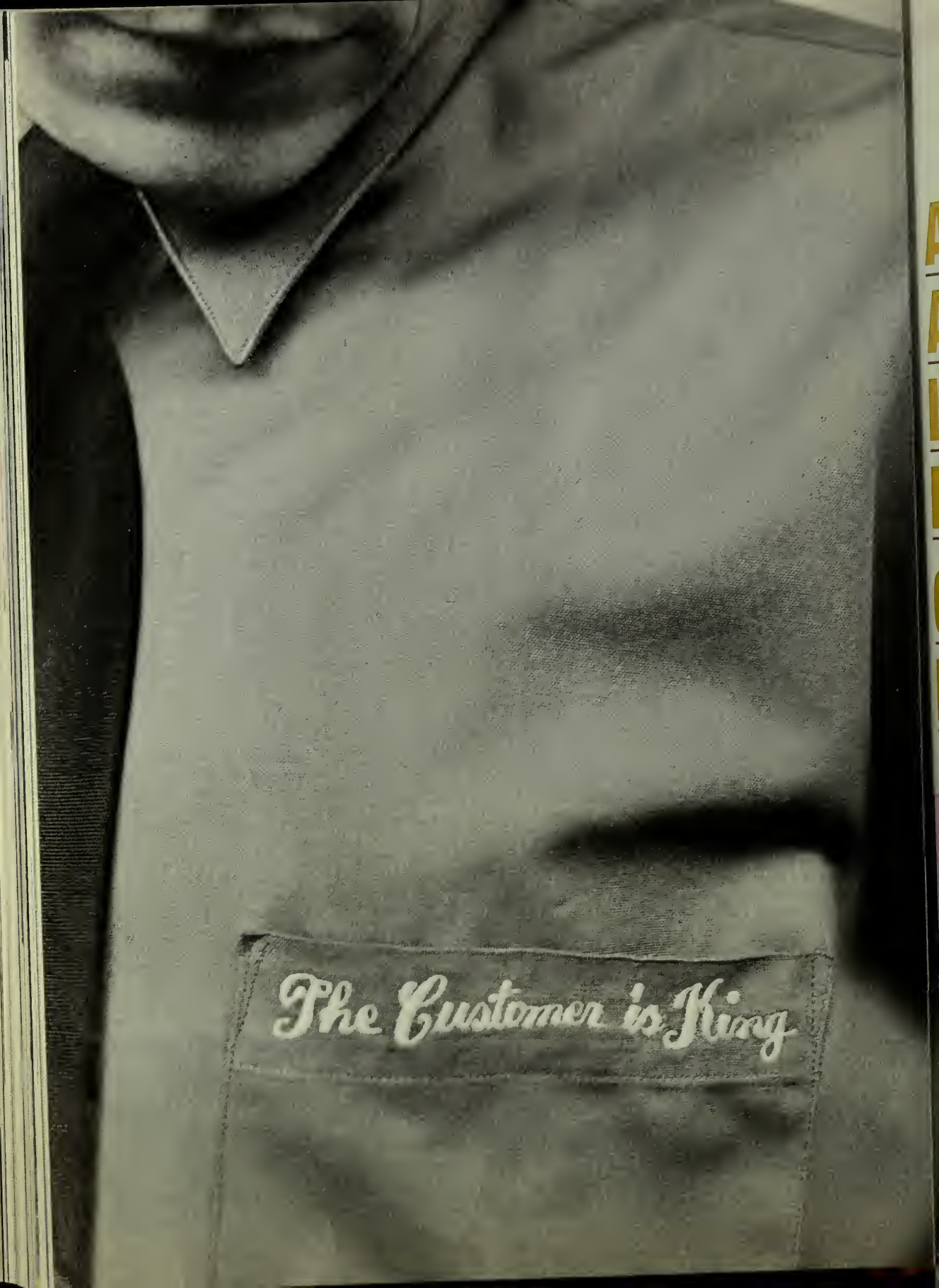
That leaves but one path: Dell must snare an amazing amount of market share in very little time. Credit Suisse

1995 The company re-vamps to reach efficiency highs. By tightening its build-to-order chain, Dell cuts inventory levels from 40 days. That helps Dell gross margins to

1997 Dell starts its assault on the server business with models costing one-third as much as rivals. And Dell jumps on the Net. By April, it's doing \$1 million in sales daily online—with 30 people, vs. the 700 it would have needed to man the phones.

1999 Thanks to the Internet boom, Dell's sales zoom to \$18 billion, and stellar execution drives inventory to record lows. The result: record profits. Dell doubles its server share to 13%, sapping rivals' main source of profits.

2001 PC sales hit a wall, so Dell launches a price war. It works. Dell becomes the No. 1 PC seller, with a 13% worldwide share. Dell's margins get crimped, yet it chalks up \$361 million in profits thanks to big cost cuts, while rivals lose \$1.1 billion.



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“Dell doesn’t make computers. They’re not in the PC industry any more than Safeway is in the food manufacturing business”

—SCOTT McNEALY, Sun Microsystems CEO

spending loads on R&D. That would leave all the innovation to Microsoft and Intel—and if they happened to get it wrong, the PC business would suddenly look like the TV industry: lots of affordable, reliable electronics, but few new killer products to spur sales. “Dell envy took the industry from ‘innovation is king’ to ‘efficiency is king,’” says Koher. “It’s a market taker, not a market maker.”

Indeed, some blame Dell for the lack of innovation that has contributed to the PC industry’s woes. Since Dell’s efficiency jihad, the R&D budgets of all the PC makers have been falling, as they race to keep up. Compaq spent 6% of its 1991 revenue on R&D. That slipped to 3.5% in 2000. “Dell has made this a cost game,” says Capellas. “Price compression is killing innovation.”

Then again, Dell never fancied himself a product innovator. Rather, his bril-

liance is in identifying innovative business models—and then executing them to perfection. Dell argues that while the company hasn’t created whiz-bang inventions, it has produced cheap computers for buyers and huge returns for shareholders. Dell says his company has injected a discipline that will be necessary for the industry’s long-term health. “The easiest way for the industry to increase profitability is for Dell to gain market share,” says Dell.

VIRTUAL TOUCH. How does he pull it off? His edge starts with the direct-selling approach he defined in his college days. By taking orders straight from customers, Dell builds its PCs to demand rather than an inexact sales forecast. That means the customers get what they want, Dell doesn’t have to build unwanted inventory, nor does it have to pay a distribution fee to a middleman like a retailer. And since Dell collects its cash an average of 30 days before it ships a PC, the approach is basically self-financing.

Dell has taken this basic idea light

years beyond any other manufacturer of complex tech products. At any given moment, there’s just four days of stock in Dell’s warehouses, down from seven days a year ago. That compares to 21 days for Compaq—a gigantic edge in a market where the price of chips, drives and other parts typically falls 1% a week. By taking advantage of the late prices in components, Dell lowers its cost of production, giving it the happy choice of either undercutting rival prices or taking a higher profit.

Dell never stands still. Last year, it required suppliers to use sophisticated supply-chain software from i2 Technologies Inc. that wires them straight into Dell’s factory floor. Now, its plants can order supplies over the Net many times a day. That lets the factory keep a few hours’ worth of parts on hand, replenishing only what it needs throughout the day. The software saved Dell \$100 million in the first six months of use.

Indeed, Dell has been a master at cutting costs with the help of the Internet. It was the first PC maker to set up an online, setting up shop in cyberspace.

HOW DELL PLANS TO TURN UP PROFITS

For all Dell’s runaway success in PCs, that game will never be hugely profitable again. To compensate, Dell knows it has to crank up share in more lucrative markets:

PCs	SERVERS	STORAGE	SERVICES	NETWORKING
Some 80% of Dell’s sales come from PCs and notebooks. If the price war doesn’t let up and margins on Dell’s PCs fall any lower than today’s 3%, the company will need to boost its worldwide market share from the current 13% to 23% by 2003 just to keep earnings flat, say analysts.	Dell has launched a price war in the low end of this market, dropping its server margins from roughly 27% to 20% in the past 18 months. To better pad profits, Dell must beat the likes of Sun and IBM, who make high-end servers with 40%-plus margins.	Dell has only a 4.5% share since this segment requires huge R&D—not Dell’s forte. Still, Dell is targeting storage because it’s a \$29 billion market, with 25% gross margins. For now, buyers want the tech smarts of IBM, EMC, and others.	Services is a \$395 billion market that carries 20%-plus operating margins. It contributes just 10% of Dell’s revenues now. Execs hope they can boost the business 30% a year. Dell’s aim is to solve customer problems with easy, software solutions instead of armies of consultants.	Dell wants a piece of the \$5 billion market for low-end networking gear used by small businesses. Dell’s plan is to underprice rivals by some 50%, gaining share quickly. But given the smallish market size, this isn’t a savior for Dell.

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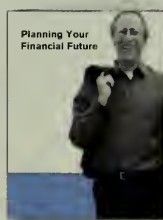
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“Dell is playing the only card they have. They’re playing it really well. But Compaq and HP are the only two companies in the PC industry that invent and innovate and, when we combine, we’ll be doing that, too”

—CARLY FIORINA, Hewlett-Packard CEO



less than a year after Netscape's 1995 IPO launched the Net boom. Today, 50% of Dell's sales are placed online. That allows Dell to do the work of hundreds of telephone sales people with just tens of online staffers. When corporate customers connect with Dell, they too get the virtual touch. Since 1997, the company has created more than 60,000 custom Dell stores on the Web for its corporate buyers. With that data streaming in, the company stays in constant touch with demand. Bemoans a former HP executive: "Michael Dell's laptop gives him more information each day than we got in a quarter's time."

Now, Dell gives customers fast, convenient service that others can't touch—including three-day delivery of PCs with all their custom software pre-loaded. When Cox Communications Inc. begged

HP to sell to it directly to avoid the hassle of going through a reseller, the company refused. "We said *no mas*," says Scott Hatfield, the cable giant's CIO who bought his 18,000 PCs from Dell and saved 20%. Health insurer Blue Shield of California switched to Dell this spring when it promised to deliver PCs in three to four days, vs. the three weeks the company typically waited with Compaq. It also saved the insurer about \$1 million on 700 new PCs—including the cost of toting away its old PCs in accordance with federal rules on disposing of health data. "Dell is simply relentless about taking market share," says Dataquest Gartner analyst Martin Reynolds. "They feel unstoppable at the moment."

Dell's rivals must feel the same way. The company is driving down PC and

server prices almost daily to steal share. Since July, 2000, the average price of a Dell computer has fallen 18%, to \$1,800. That's wooing entirely new clients. U.S. Bancorp Piper Jaffray analyst Ashish Kumar says that in August, 40% of Dell's current corporate accounts were new wins, vs. 10% historically.

Bold talk by competitors about matching Dell's prices typically doesn't last long, either. After pledging to match Dell in May, Gateway backed off that claim two months later. Then on Aug. 29, the company announced that it will lay off 4,600 workers and retreat from foreign markets. Compaq also claimed it could withstand Dell's price war. Under Capellas, Compaq has made huge improvements in asset management by cranking

BIG CUTS

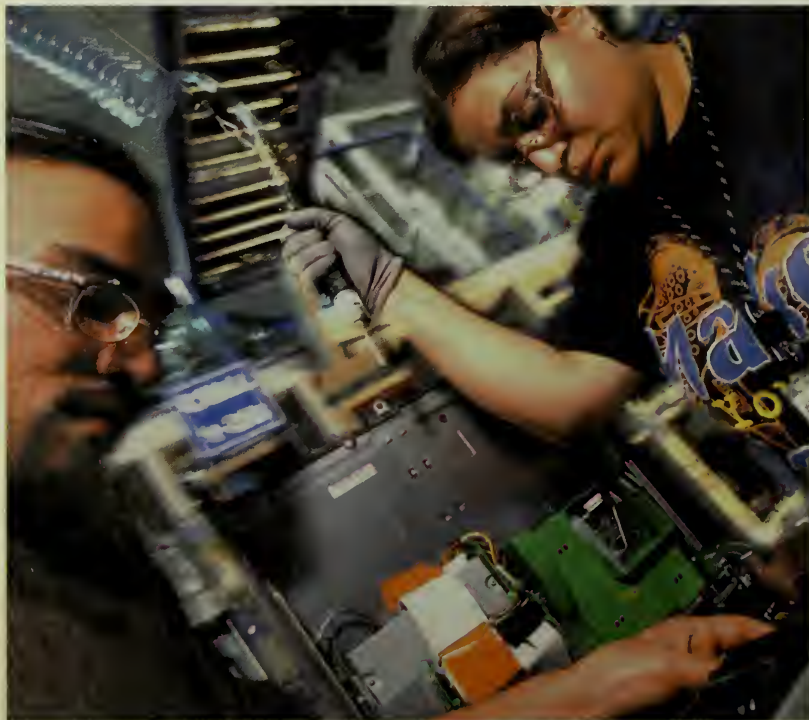
Dell has stayed solidly in the black only by laying off 5,000 workers

up its own direct sales effort and slashing its inventory. But it still can't earn a decent return and has lost off Dell at the same time—a key reason Capellas needed to sell the company.

HP, says analyst Brooks Gray of Technology Business Research.

WORRIES. The failure of rivals to make good on their claims has emboldened Dell. On the day the HP/Compaq deal was made public, Dell banged out a gleeful e-mail to a *BusinessWeek* reporter: "It looks like the market has spoken on this deal," wrote the 36-year-old native Texan. He punctuated the missive with a grinning happy face.

Still, it's not all smiles at Dell's Round Rock (Tex.) campus. Market watcher International Data Corp. expects PC industry revenues to fall in not only this year, but another 2% in 2002—partly because buyers seem content to hold on to their PCs longer than in the past. There could be a small sales uptick when Microsoft's Windows XP software ships in October, but not enough to



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“Dell has made this a cost game. So this isn't just a market-share shift that's going on. It's a shift in the role PC companies play in innovation. Price compression is killing innovation”

—MICHAEL CAPELLAS, Compaq Computer CEO

verse the bigger trend: The average life span of a corporate PC could rise to four years by 2004, from 3.3 years in 1999, says researcher Gartner.

What's more, it's not clear that markets Dell wants to turn into commodities, such as servers, storage, and networking, are ripe for the conversion. Starting with the desktop in 1984, Dell has been able to commoditize other Wintel markets—first the notebook, and then low-end servers. It lets rivals pioneer a market and then charges in with its low prices and low-hassle service. But now it is having to move out of its comfort zone, as it targets markets that require tons of white-glove customer service and where Microsoft and Intel have yet to earn their stripes.

Dell's future success in servers, for example, depends on acceptance of Microsoft's Windows 2000 server software and Intel's Itanium chip. Technology

EFFICIENT

Dell wants to cut the cost of cranking out high-end products, too

from Intel and Microsoft has become standard for many lower-level jobs, but companies still rely on higher-end Unix machines and IBM mainframes for the biggest, most lucrative tasks. Worse, Dell has thinned its already slim ranks of engineers in two layoffs this year. Since Dell already spends less than the rest of the industry on R&D, that could hurt its nascent efforts to develop more robust servers. Says Sun Microsystems CEO Scott G. McNealy: “Dell is a grocery store. They're not in the PC business any more than Safeway is in the food manufacturing business.”

Storage could be even more challenging for Dell. This market is expected to hum along at 15% growth over the next few years, thanks to the unending need for companies to store the rising tide of Net data—whether or

not they buy other gear. With margins still a hefty 25%, the business is dominated by tech heavyweights EMC, IBM, and Network Appliance.

They have been the storage suppliers of choice because they've developed sophisticated products to handle huge amounts of data from a variety of different computers. Indeed, Network Appliance CEO Daniel Warmenhoven figures just 20% of storage sales could be called commodity. Storage executives say it will be years before the bulk of the market will be vulnerable to Dell.

TOUGH BOSS. Dell realizes his storage prize is still off in the future. Insiders say that Dell is in talks with EMC to form a strategic partnership that would let Dell sell EMC storage devices with its servers. That way, it could get a cut for landing new business for EMC, and it wouldn't lose server business to rivals who have their own storage—particularly the new HP, which will get Compaq's \$5.2 billion storage unit that dominates the lower reaches of the storage

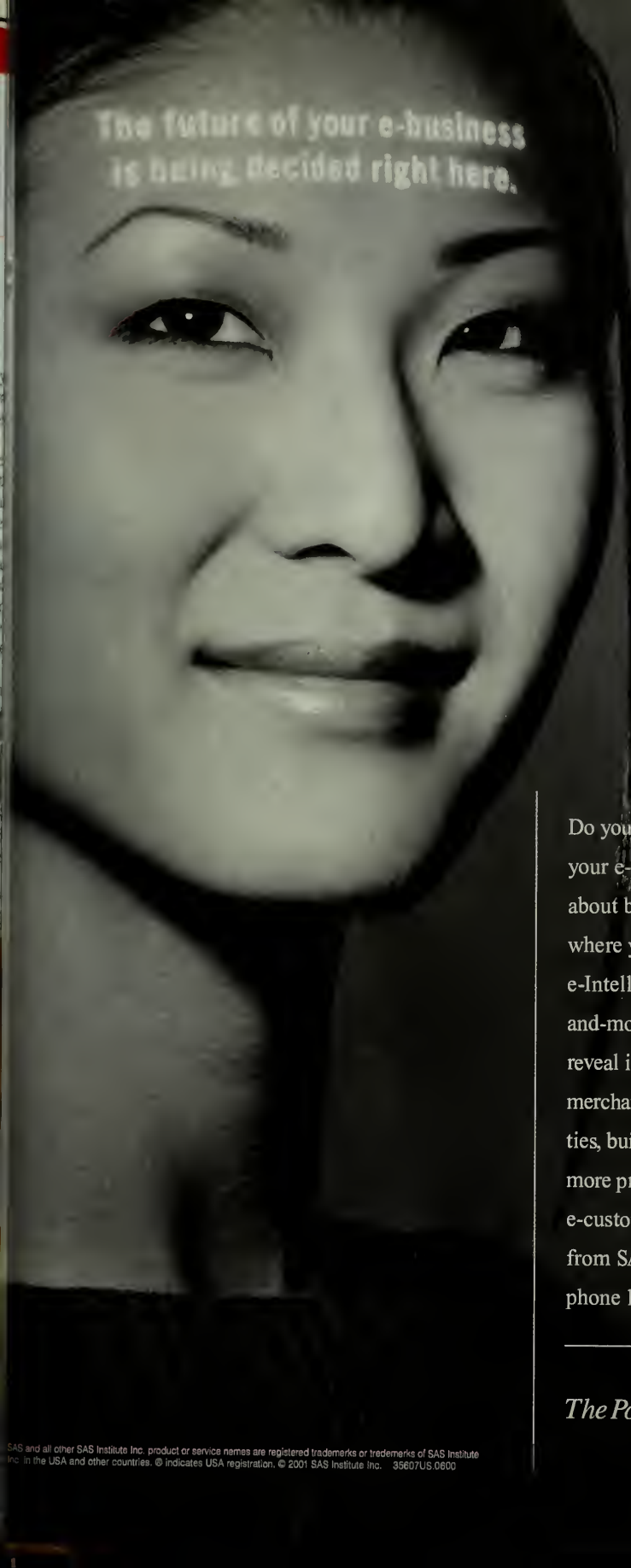
industry. “If Dell's worried about anything [regarding HP's purchase of Compaq], it has to be storage,” says former Dell senior executive Carl Everett.

Dell is confident his direct approach will win in the end. His response to snags is to push managers to crank harder on his tried-and-true model. When top managers in Europe didn't deliver big market-share gains last year, they were shown the door. Says President Kevin Rollins: “They didn't completely understand the direct model. They just didn't get it. So we had to place a lot of our management team.”

Is Dell sticking too long with the method that has made him a giant name in 20th century business? He insists that to let up now would be foolish. “I'm going full blast and I'm not slowing down,” says Dell, whose 14% stake in the company is worth an estimated billion. “I'm having a great time. This is fun.” Unfortunately, in his business, fun can turn to agony in a nanosecond.

By Andrew Park in Austin, Texas, and Peter Burrows in San Mateo, California





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TELEVISION

MEDIA GIANTS ARE GLUED TO LATINO TV

With ad sales growing, potential buyers are circling

The Hispanic Television Network is so far a network in name only. Launched early last year, HTVN reaches scarcely 15% of the country. It's essentially a patchwork of 20 TV stations and agreements with cable systems, most of which have yet to air their first salsa music hour. In the 18 months since launching, HTVN has lost 51.7 million on \$1.8 billion in revenues. But those numbers haven't deterred several of the largest media companies from going to Fort Worth to sound out potential deals. "They're names you'd recognize," says HTVN Chief Operating Officer Michael Fletcher. "I don't think anyone can be in the business [of Hispanic TV] right now and not get calls like this."

In fact, to media giants caught in the frenzy to consolidate, no business seems hotter these days than Spanish-language TV. For months, Telemundo, the No. 2 Hispanic TV network, based in Hialeah, Fla., has been fielding inquiries from Walt Disney, Viacom, AOL Time Warner, and General Electric's NBC, industry insiders say. According to these sources, Viacom made a bid earlier this year—rejected as too low—for Los Angeles-based Univision Communications Inc., the top network in the field, with an esti-

mated 80% of the Hispanic market. Viacom President Mel Karmazin says there was never a "formal offer" for Univision. But at Viacom's annual meeting in May, he put shareholders on notice that he's set to buy Hispanic TV assets at the right price. Univision refused comment.

At a time when other TV audiences are shrinking, Hispanic TV is a media darling because its viewership just keeps on growing. So far this year, an average of 3.7 million viewers catch Spanish-language movies and south-of-the-border *telenovelas* (soap operas) on either Telemundo or Univision, according to Nielsen Media Research, an 8.7% jump over the year before. Those numbers helped the two networks record

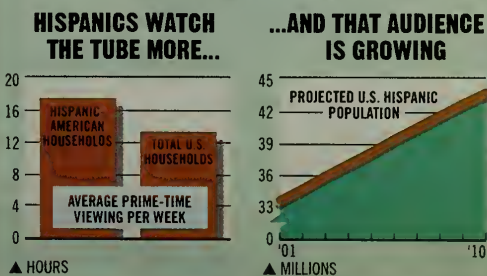
double-digit ad-sales growth for the coming season even as the slowing economy has slashed ad sales elsewhere in TV-land. The U.S. Hispanic population, now 33.6 million and the country's fastest-growing segment, is expected to top 43 million by 2010 (charts).

SERIOUS VIEWERS. What's more, Hispanics tend to watch more TV, on average, than other viewers, are younger, and have rising disposable income. By 2010, U.S. Hispanics will spend \$1 trillion a year on goods and services, up from the \$444 billion in 2000, according to Standard & Poor's/DRI, a unit of The McGraw-Hill Cos., *BusinessWeek's* publisher. With those numbers, "they're no longer an afterthought for us," says Andy Donchin, director of broadcast for media buyer Carat North America, which has stepped up ad sales on Hispanic TV for clients such as Pfizer Inc. and Alberto Culver hair products.

Big Media's new interest in Hispanic TV is part of a push to collect niche programming, such as the Walt Disney Co.'s recent purchase of the Family Channel. And ethnic TV is especially hot. Last year, Viacom paid \$3 billion in stock for Black Entertainment Television, a price industry insiders say was 20 times BET's cash flow, or nearly double what traditional TV outlets



THE LURE OF SPANISH-LANGUAGE TV



Data: Nielsen Media Research, U.S. Census Bureau

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Media

command. "Viacom was saying to the rest of us that niche players matter and that they were willing to pay up for them," says one media executive.

HOT PROPERTY. Those kinds of multiples have driven up the price for Univision, which draws an average 1.7 million households a night, five times BET's audience. With its 32 TV stations and Galavision, the top-rated Hispanic cable channel, Univision could more than double its value within a year, to \$11 billion or \$55 a share, predicts P. Gordon Hodge, an analyst with Thomas Weiskopf Partners LLC. Earlier this year, Viacom offered \$30 a share, or about \$7 billion, say industry sources, but was rebuffed. Instead Univision, controlled by former boxing promoter A. Jerrold Perenchio, expanded last year into music and early 2002 intends to launch a second network aimed at English-speaking Hispanics. Its drawing power is huge. Last year, its Spanish-language movie *La Delicias del Poder* drew 1.1 million more Hispanic viewers than NBC's highest rated movie, *Titanic*. And its nightly *Noticiero* TV news show often outdraws the Big Three network offerings.

In this climate, once-troubled Telemundo is also drawing intense interest. The privately held network has rebounded from a 1993 bankruptcy to build its audience by 48% after revamping its programming in 1997. It delivers one-fourth of Univision's audience, but Telemundo's ratings in the May sweeps climbed 30% among the prized 18-49 age group with hot shows such as *novela Betty La Fea* (Betty the Ugly). Taking on Univision's popular afternoon talk show *Cristina*, Telemundo's *Laura in America* became a huge hit with 1 million viewers daily. The bidding so far for Telemundo is said to have hit \$3 billion, a sharp hike from the estimated \$700 million paid by its majority owner Sony Corp. and John C. Malone's Liberty Media Corp. in 1997. The company has been adding distribution, spending \$304 million last year to expand its station group to 24, including in top Hispanic markets Los Angeles and Dallas.

A bid for Telemundo, expected in the coming weeks, could spark bidding for other Hispanic TV assets, including those that produce programs. Some cable companies such as AOL Time Warner and AT&T are said to be pursuing Mexican TV producer TV Azteca, whose year-old plan to launch a network with TV station owner Pappas Telecasting Cos. has been slow to roll out. As for the fledgling HTVN, Michael Fletcher says he's got his cell phone handy.

By Ronald Grover in Los Angeles



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JAPAN

SAYING SAYONARA

Nissan is closing plants, cutting jobs at home—and facing little protest

For 39 years, Nissan Motor Co.'s Murayama plant outside Tokyo was a prime example of Japan's auto-making prowess. At its peak, the company's flagship factory employed 5,000 people, cranked out 453,000 passenger cars a year, and was deemed so efficient that in 1995 it won a Japanese Deming award for quality control.

Today, the Murayama plant is being bulldozed, and the land it sits on may be sold to a Buddhist religious order. Several months ago, Carlos Ghosn, the CEO installed by controlling shareholder Renault, ordered the place shuttered as part of his efforts to return the auto maker to long-term profitability. The factory's equipment has been auctioned off or scrapped. Production of six models has been shifted seamlessly to three surviving plants. Several hundred people have lost their jobs.

Murayama's demise has become a symbol of the new order in Japan. It's now a country where lifetime employment is becoming a memory and a *gaijin* CEO can mothball plants and shift production offshore with barely a ripple of labor unrest. Murayama is the third—and largest—plant closed since Renault bought its stake in Nissan in early 1999.

There's more: The company has also just decided to shift all production of its export-only Maxima sedan out of Japan to an existing plant in Tennessee. And it aims to open a \$1 billion minivan and sport-utility factory in Canton, Miss. "Everything has proceeded more smoothly than I expected," says Hisayoshi Kojima, Nissan's executive vice-president in charge of the plant closures. "So the question now is not why we closed so many plants but why we didn't do it earlier."

Japan's other carmakers have been asking themselves the same question as they, too, quietly go about cutting domestic production. Last year, just 10.1 million vehicles were made in Japan, down from 13.5 million in 1990. Meanwhile, the num-

ber made overseas has grown by almost half. Honda Motor Co. has trimmed its domestic-plant workers by about 2,000, or 7%, since 1990, even as it has boosted offshore production by 30%. Industry leader Toyota Motor Corp. closed two Japanese assembly lines last year, though it has kept production of its most expensive cars at home. Even Mazda and Mitsubishi, both latecomers to the restructuring push, say they will close one factory apiece and cut jobs at home and abroad.

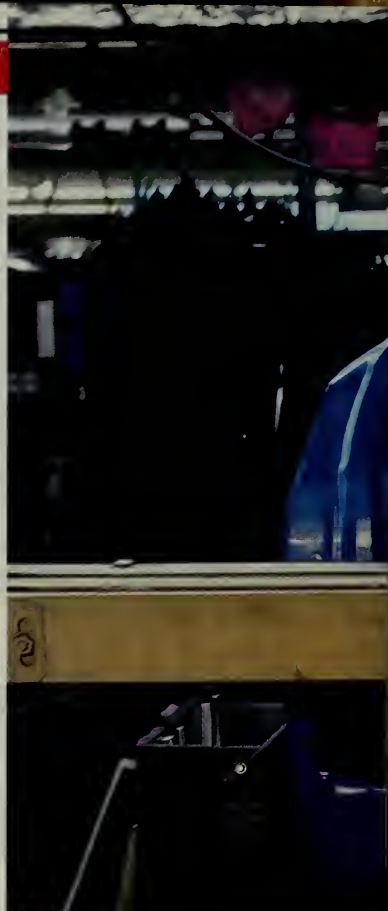
BUY LOCAL It's easy to see why Nissan and its Japanese rivals are finally doing what they postponed for so long. With the home market weak and demand for Japanese models still strong in North America, it makes sense to make cars where the buyers are. Doing so avoids currency swings and helps sell cars to consumers wary of buying "foreign brands." In its American push, Nissan is rushing to catch up with Honda and Toyota, both of which have been steadily expanding output in the U.S.

For Nissan, the payoff is clear. The closures of Murayama and two smaller plants will boost operating capacity to an average of 74% this year, up from 52% in 2000. The company's increased efficiency, plus continued cost-cutting gains, are expected to boost Nissan



BILLION-DOLLAR PLANS

Ghosn and Governor Ronnie Musgrove review a model of a plant being built in Mississippi





LONG COMMUTE

Many workers were shifted to Oppama, 50 miles away

jobs. An additional 200 employees who couldn't make up their minds stayed behind in Murayama, stamping replacement parts such as doors and hoods at a small facility on the factory lot. But that workshop will close by 2004, at which point they must move or join the unemployment line. "I have a mortgage, three kids, and a wife who works the night shift at a hospital, so I really don't know what to do," says Noboru Kami, 46, who has worked in Murayama for 27 years. "It's an excruciating decision."

FAMILY STRAIN. Workers asked to move to Oppama along with the production of the Cube and March subcompact models were equally conflicted. Rather than sell their homes and transfer their kids to new schools, some work Monday through Friday in Oppama and drive the 50 miles to Murayama on weekends. "I've never had to live apart from my family, so it's been tough on all of us," says Eigo Sasaki, a 31-year Murayama veteran and father of two.

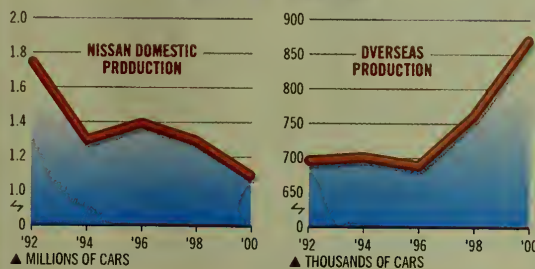
It's going to get tougher. Over the next half-decade, according to a study commissioned by the Confederation of Japan Automobile Workers' Unions (JAW), Japan may lose 143,000 of about 800,000 auto and parts-assembly positions. That's on top of the nearly 100,000 such jobs that have disappeared in the past decade, putting further pressure on the government to

profit 21%, to \$2.9 billion, on sales of \$53 billion for the year ending next March, topping last year's record earnings. The carmaker paid its shareholders dividends of 6¢ a share last year, the first such payment in three years.

Nissan's actions also underscore a major change: Japanese unions' growing acceptance of downsizing is inevitable. When Ghosn announced in 1999 that his Nissan Revival Plan would require 10,000 job cuts globally, labor unrest was widely expected at the company's Japanese plants. But Ghosn convinced labor leaders that, while their bank and file would endure some pain, the downsizing would lead to sustainable profitability. "We bought into Ghosn's vision, and so far, he has met all the targets," says Akira Takakura, vice-president of the All Nissan Motor Workers' Union. Ghosn also gained credibility by unveiling a higher-than-expected wage hike in March, after a two-year freeze. That will make it politically easier to eliminate the other 6,800 jobs he needs to cut before he hits his reduction target of 21,000 by 2003.

Despite Ghosn's success in wooing Nissan's union, this is still a Japanese-

OUT OF JAPAN



Data: Nissan Motor Co.

style restructuring, less brutal than what would happen in America. Nissan execs made an important concession by agreeing, in principle, to offer workers at closed plants other jobs. More than two-thirds of the employees in Murayama transferred, including 700 who went to a plant in Oppama, near Yokohama. "We didn't throw anybody out in the cold," says Yoichi Ochi, the human-resources official in charge of winding down operations at Murayama.

The catch? Keeping a job meant abandoning Murayama, where many employees had spent their entire working lives. That was too much to ask for some 400 workers. They either accepted early retirement or had to leave their

address unemployment (page 110).

If the unions don't figure out a way to hold on to auto jobs, more plants will close, and more company towns will feel the pain Murayama has suffered. While tax revenues from Nissan have been negligible ever since the company slipped into the red eight years ago, local businessmen are starting to hurt. Mitsuji Migita, manager of a stew shop across from the factory's main gate, isn't happy to see Nissan leave the area. "We still have our regulars," he says. "But there are fewer of them now." Getting by with less: It's a hard lesson for Nissan, its rivals, their workers, and Japan itself.

By Chester Dawson in Tokyo

COMMENTARY

By Irene M. Kunii

JAPAN'S JOBLESS NEED MORE THAN A HANDOUT

It has been a tough decade in Ota Ward, a community of small factories, tiny shops, and unassuming homes in southern Tokyo. Since the early 1990s, some 30% of Ota's 8,000 *machi koba*, or family-run factories, have closed as high-tech manufacturers shifted production to cheaper China and Southeast Asia. That trend will quicken now that the likes of NEC Corp. and Toshiba Corp. are cutting domestic production in the wake of slowing global demand. As a result, says Tomohiro Kozeki, the author of several books on *machi koba*, "many are now thinking about closing their shutters for good."

As it goes in Ota, so it goes in factory towns across Japan. Between January and July, the manufacturing sector has lost 440,000 jobs, or nearly 4% of its total. This has helped push the seasonally adjusted jobless rate to a record 5%, or nearly 3.4 million Japanese. Factor in people who have given up looking for work, and the unemployment rate exceeds 10%, according to the government Cabinet Office.

A REAL REMEDY? No surprise then that populist Prime Minister Junichiro Koizumi is vowing to address the problem. He has instructed his Cabinet to draw up proposals to help the jobless. He is aiming for a \$17 billion spending package that would provide job training and extend unemployment benefits beyond the current limit of 11 months.

That's an encouraging start. But Koizumi and his Liberal Democratic Party will have to do much more than throw money at the problem: They must create the conditions that will allow ailing companies to downsize. That, of course, means Japan will have to learn to live with the chronic unemployment rates of other industrialized nations. And dealing with this harsh new reality will require a range of initiatives. Among them: accelerating deregulation of

the economy so the private sector can create jobs, making it easier for companies to legally lay off full-time workers, introducing retraining programs, and finally, helping Japanese accept the idea that a job for life with one employer is history.

Pink slips don't exist in Japan. There are no laws prohibiting layoffs, but the courts have ruled that a company may only let workers go if it's facing bankruptcy. As a result, firms must wait until they are too sick to recover before they can take

mist at Tokyo's Keio University, has a better idea: allow a variety of institutions to take part and provide loans instead of subsidies. "Since it's an investment," he says, "these adult students will be much more serious about the programs they enroll in."

Ultimately, the Japanese public itself must change its attitude toward unemployment. The stigma of losing one's job is such that older workers often won't look for new work. Even if they do, age discrimination is so prevalent that few workers in their



CHANGES

Koizumi must allow Japanese companies to downsize—and improve the way workers are retrained

A BUSY EMPLOYMENT CENTER IN SHINJUKU

such a step. Companies need to be given more freedom so they can retrain in a slowdown—and then rehire as demand rebounds.

At the same time, the government needs to hack away the thicket of restrictions that protects domestic industries. Banking, telecom, trucking—they all labor under heavy regulations that keep competition to a minimum. Deregulation would enable others to enter the market and create jobs. For proof of the merits of liberalization, look at Japan's booming—and largely deregulated—wireless industry, one of the few growth areas in a mostly moribund economy.

The government also needs to rethink retraining. Last year, Tokyo gave up to \$2,500 to workers taking courses in New Economy subjects such as software and Web design. But officials chose the courses and schools. Atsushi Seike, a labor econo-

50s land advertised jobs. Keio's Seike is lobbying for antidiscrimination laws that will make it easier for older and foreign workers to be part of a more mobile labor force.

As the global downturn clips demand for Japanese technology, the pace of restructuring in manufacturing is bound to pick up. That will further depress demand and force other sectors to revamp. And Koizumi's pledge to cut pork-barrel projects will hit the construction industry hard. Many of the country's 6.3 million hard hats could find themselves out of work. As he contemplates the growing ranks of the jobless, Koizumi can choose to ease the pain somewhat with a few extra benefits—or tackle the radical changes needed to move them back into the workforce.

Kunii writes about Japanese technology from Tokyo.



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INDONESIA

STAYING THE COURSE

Foreign companies are thriving amid chaos

You wouldn't know it to look at the place, but the cavernous gray shed near the central Javanese city of Yogyakarta is one of General Electric Co.'s most cost-effective lightbulb factories. Hang on. An ultracompetitive factory in the heart of Indonesia? Where reports of political turmoil and violence seem to presage the very disintegration of the nation?

It's true. Last year, GE Lighting Indonesia cranked out 90 million lightbulbs of all shapes and sizes. Sure, the factory can't match the speed of the company's automated plants in the U.S. and Europe. But thanks to an abundance of cheap labor, glass, and wire, it can make bulbs at a fraction of the cost. Best of all, the plant is miles from the ongoing unrest. "This is a relatively peaceful place," says General Manager Dhananjay Gupta. "We don't have bomb blasts, demonstrations, or riots."

When the Indonesian economy collapsed four years ago, a common belief was that multinational manufacturers would flee. In fact, management consultants estimate that fewer than 1 in 10 of the 3,000 foreign companies in Indonesia have left. Manufacturers of everything from Energizer batteries to Nike running shoes to L'Oréal cosmetics are determined to stay.

RISKY BUSINESS. The math is simple: Indonesia boasts some of the lowest costs in the world, a big domestic market, and proximity to the rest of Asia. As a result, some companies are expanding. Coca-Cola Co. plans to open a new bottling plant next year, while Renault has announced a joint venture with Suzuki Motor Corp. assembler Indomobil that will assemble and distribute Renault cars. Over the past three years, the government has approved \$26.2 billion in new foreign investment.



KEEPING THE PEACE

Nike has a full-time labor-relations monitor

up on cracking the domestic market and switched to an export strategy. Nearly 70% of the cosmetics produced at L'Oréal's Jakarta plant go overseas—Malaysia, Singapore, Thailand, Hong Kong, Taiwan, and China.

Then there are those manufacturers that simply see opportunity in chaos. Minneapolis-based Vision-Ease broke ground on a plant near Jakarta amid nationwide riots. Months later the plant opened at a cost of just \$2.5 million and is today exporting lenses to Europe and the U.S.

Of course, not all companies are immune from Indonesia's political unrest. Nike Inc., for example, has a full-time labor-relations manager at its Jakarta headquarters. His job is to prevent disruption of the company's operations.

Of course, operating in Indonesia is not risk-free. It requires patience, adaptability, and an ability to think like a local. U.S. or European executives are not necessarily equipped for the task. So companies such as Coca-Cola Co. and lensmaker Vision-Ease Lens Inc. are recruiting Indian managers to run their Indonesia operations. Indians are paid 60% less than Americans. And their experience in dealing with the vagaries of doing business in India prepares them better to do the same in Indonesia.

Multinationals, however, are being forced to accept a bottom-line truth: Because of the wealth-destroying impact of the 1997 financial crisis, foreign products are much more expensive for local consumers. To stay in the game, Procter & Gamble Co. and Unilever Group now make smaller shampoo and detergent sachets that the newly poor can afford. For its part, L'Oréal of France has given

erations. In mid-June, Indonesian workers went on strike to demand a minimum-wage hike. Mindful that local factories produce 31% of the footwear it sells worldwide, Nike dispatched a monitor to see if the production lines were in danger of being halted. It turned out to be a false alarm, but companies must be vigilant all the time.

Tamping down local unrest isn't easy, however, for mining and oil companies. Exxon Mobil in Aceh, Freeport-McMoRan Copper & Gold in West Papua, and Caltex (a Chevron-Texaco joint venture) in Riau have all suffered production cuts as a result of protests from local communities, which are demanding greater revenue split from the government in Jakarta.

While such problems may deter new investors, veterans take the long view. "If you're British Petroleum, you see 20 years of gas, not two years of political turmoil," says John Kurtz, country manager of management consultancy Arthur D. Little Inc. in Jakarta. "If you're Nestlé, you see 225 million people with long-term spending growth—not the sudden undertow of urban poverty." For all its turmoil, Indonesia represents not danger, but opportunity.

By Michael Shari in Jakarta

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COMMENTARY

By Stephen Baker and Andy Reinhardt

CAN NOKIA KEEP OUTRUNNING THE PACK?

They used to be the Scandinavian twins. Sure, they tussled, but cell-phone makers Finland's Nokia Corp. and Sweden's Ericsson also worked together on wireless standards to orchestrate a cellular world they could dominate. Through the '90s, they looked poised to turn the rest of the mobile-phone industry into a mere appendage of their wireless northlands. Yet in the past year and a half, these twins have embarked on separate paths. And this fork in the road could take the entire phone industry on a dramatic detour. It could even create a new peril for mighty Nokia.

BIG SHIFT. What happened? In short, Nokia, with its superior skills in brand marketing and customer-friendly technology, kicked the stuffing out of the industry, forcing Ericsson, along with other cell-phone makers, to find powerful partners. In the past two years, Ericsson has teamed up with Microsoft on Web-browsing software and with Sony on multimedia phones.

Most important, Ericsson handed off the task of actually making its phones to contract-manufacturing giant Flextronics International in Singapore. And in early September, Ericsson announced plans to license its cellular technology to virtually all comers. This means that state-of-the-art cellular technology, formerly the domain of a small club, will now be available to any gadget-maker that wants to turn a camera, palm-top computer, or music player into a wireless device. Wireless is becoming a commodity.

These days, Ericsson is a pretty sick company, with billions in losses

and no end in sight to its pain. Nokia, too, has suffered plenty from the industry crash. Its shares have fallen from a high of \$60 to \$13 in the past year and a half. Still, Nokia alone rakes in earnings. And its Sept. 11 announcement that it would meet its third-quarter earnings targets, with margins at a healthy 15%, provided a welcome bit of news that drove a rally in the stock. So why do

dards, manufacturing, architecture, and design," says Ron Smith, general manager for Intel's wireless communications and computing group.

If mobile phones follow this Wintel model, what happens to the only go-it-alone warrior? "I see Nokia following the path of Apple," says Roel Pieper, a former top executive at Tandem Computers and Royal Philips Electronics. In other words,

Nokia, like Apple Computer Inc., could become a technology for connoisseurs—a technology whose influence steadily shrinks.

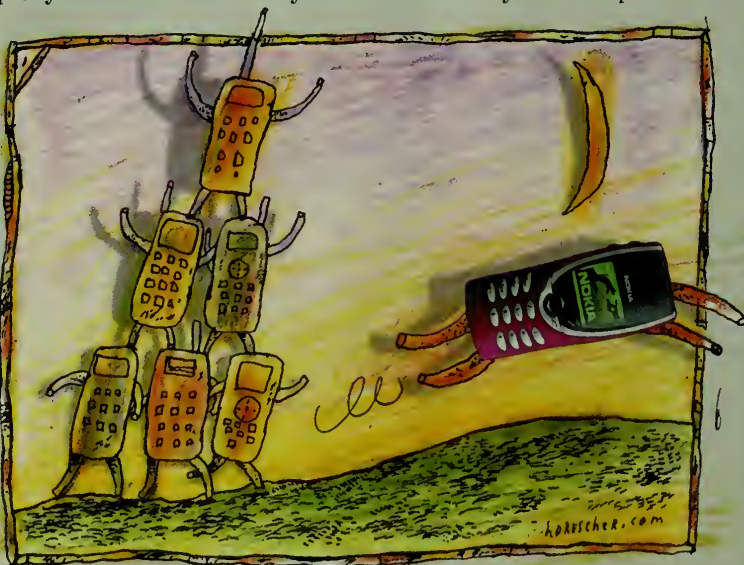
HOT STUFF? Naturally, Nokia rejects this thesis. "People who compare computers to mobile phones do not understand our industry," says Executive Vice-President Anssi Vanjoki. "We're selling branded consumer goods, not a big box."

But just as the battle for industry

dominance is moving into its next stage, the Finns have displayed surprising weaknesses. They built a whole new strategy around a mobile Net technology that stalled: Consumers complain that the first generation of Web phones are balky and awkward. Nokia didn't foresee that the rush to buy licenses to operate the next stage of the wireless Web would send its biggest customers, phone companies, into a morass of debt. Now, these telecoms can't pull off the rapid buildout in wireless Web phone systems Nokia expected.

This all bodes ill. Nokia still has a big lead in a key industry. But if the tumultuous history of high tech proves anything, it's that leaders can turn into losers with one false step.

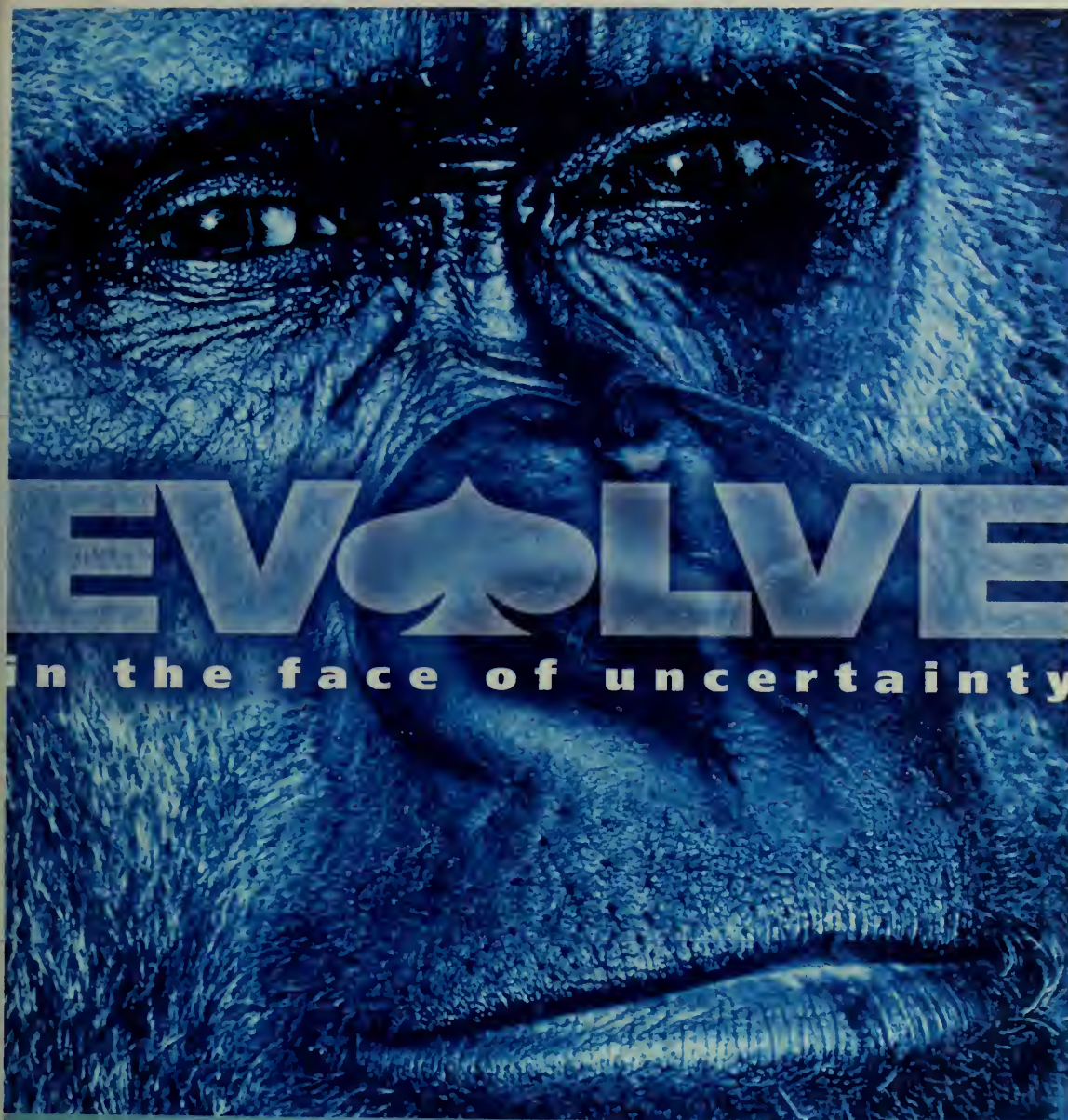
Baker and Reinhardt cover technology from Paris.



If the also-rans succeed in turning wireless into a cheap commodity, Nokia could stumble

the Finns need to worry about the desperate moves of the Swedes?

A look at the history of the computing industry provides an inkling. Cell phones, say veterans of Silicon Valley, are following the route of the PC. Instead of one company making the entire machine, specialists such as Intel Corp. and Microsoft Corp. will soon be turning key pieces, such as chips and software, into their own kingdoms, especially as cell phones turn into wireless Internet centers that perform computing and e-mail tasks. "The handset industry is moving toward Intel's strengths: stan-



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The main challenge: Coming up with incentives that won't let lawbreakers off scot-free

accounts—out of the tax man's reach. Another goal: to give people in Europe's underground economy incentives to go legit.

The amounts of money involved are substantial. Analysts estimate that a total of \$850 billion in annual earnings in the euro zone goes untaxed. While some of the tax-evaders are criminals, most are ordinary Europeans trying to duck the countries' onerous levies—the counterpart of a generous social safety net. Scofflaws range from parents who pay nanny off the books to contractors who declare only part of workers' income. And they're found across the Continent. The Germans, with Europe's biggest economy, manage to conceal \$268 billion from the tax collector every year. But Italians are the

champs: With a much smaller economy, they conceal \$250 billion. In addition, Europeans have some \$759 billion stashed away in foreign bank accounts, much of it for tax reasons.

TIMELY FILLIP. The governments' greatest hope is to lure back offshore money, which is mostly denominated in euro-zone currencies, for deposit in local banks or investment in local capital markets where it can work productively, be tracked by the authorities, and get taxed. The politicians also want those who work mainly for cash to save it in large-denomination banknotes to be drawn into the official economy where their earnings can be regulated and taxed.

To be sure, the stimulus gained from attracting this money would be a catch-22 thing. But given the apparent depth of the global economic downturn, it could not come at a better time or

EUROPE

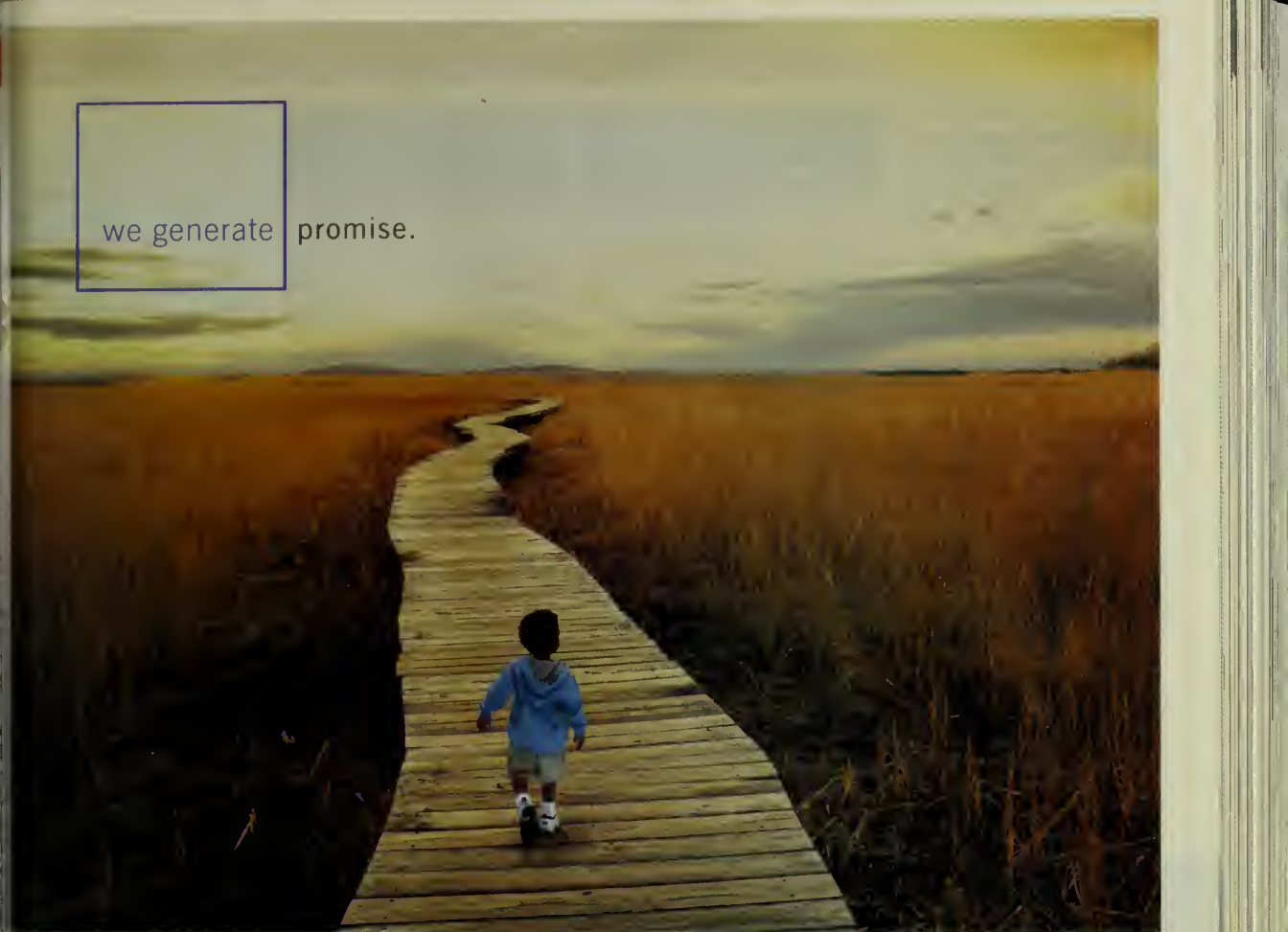
OUT FROM UNDER THE TABLE

The euro conversion may unleash a flood of cash

Call it economic stimulus, European style. The introduction of euro coins and notes on Jan. 1 will be a huge logistical headache, no question. The euro zone's 12 finance ministers, however, have a peculiar perspective on it. Many of them consider the new currency a gift, a

chance to give their flagging economies a jolt at no extra budgetary cost.

The dream is to turn the two-month window, when the euro replaces francs, marks, lire, and other national currencies as legal tender, into a sort of drag-net to pull back the huge pile of cash that Europeans have stashed in offshore



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International Business

the economies of the euro-zone countries. "It could add as much as 0.9% to euro-zone GDP," says Emmanuel Ferry, an analyst at Paris brokerage Exane. In Italy, a properly designed tax-amnesty scheme could draw back as much as 50% of the offshore funds, estimates Giuseppe Marino, a professor of international tax law at Bocconi University in Milan.

Indeed, designing it will be the rub. Policymakers face the tough task of coming up with a mix of incentives that will bring money out of the shadows without giving the appearance of letting lawbreakers off scot-free. Unfortunately for European authorities, they'll probably be swimming against the tide. There's evidence that people are already hustling cash out of the various euro-zone countries in advance of the conversion deadline. The idea is to avoid attracting tax authorities' attention next January by bringing sacks of cash to the bank to exchange. German police say that these days they regularly apprehend people on the autobahns headed for Luxem-

Europe's Black Economy at Home...

	UNTAXED EARNINGS* (BILLIONS)	SHARE OF GDP
ITALY	\$250	23%
GERMANY	268	15
FRANCE	125	11
SPAIN	78	17
EURO-ZONE	859	14

*2000 estimates

Data: European Commission, Interpol, Informal Economy Research Center

bourg and Switzerland—Germans' favorite tax havens—with as much as 40,000 Deutschmarks stuffed in their car trunks. Spanish police are encountering more people taking large amounts of pesetas into Andorra and Gibraltar. "One old man we stopped on his way into Gibraltar had 33 million pesetas [\$182,000] stuffed in his jacket," says a spokesman for Spanish customs.

The primary reasons Europeans evade taxes are high marginal income-tax rates, taxes on accumulated wealth, and the choking bureaucracies that monitor tax compliance, among other things,

...And Abroad

	MONEY STASHED ILLEGALLY OFFSHORE** (BILLIONS)
ITALY	\$320.00
GERMANY	250.8
FRANCE	104.9
SPAIN	105.2
EURO-ZONE	759.0

**As of June, 2001

Data: National central banks, Bank for International Settlements, Informal Economy Research Center, *BusinessWeek* estimates

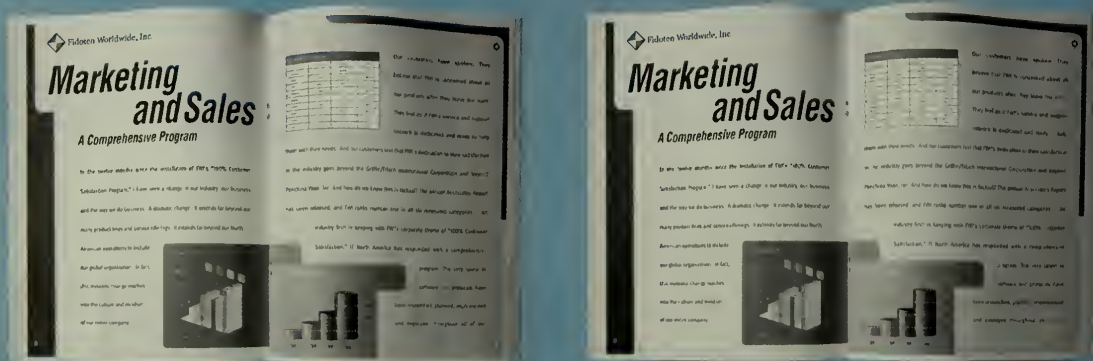
and make it hard for small businesses to operate legally, let alone make a profit. And many immigrants—among them longtime residents—have little choice but to join the underground economy because it's so hard to legitimize their status.

Exane estimates that euro-zone residents keep as much as \$161 billion in cash. That's equivalent to 2.9% of the zone's gross domestic product. France and Spain are trying to lure illicit money

into legitimate accounts by ruling that, between December, 2001, and June 2002, banks need report only cash deposits of more than \$9,000. The normal reporting threshold is \$7,000. Theoretically, this should make small-time offenders, who are the real targets of amnesty programs, feel less anxious about dragging in their wads of dough.

Italy has become ground zero for the clean-money effort. There, Treasury Minister Giulio Tremonti is making Europe's most aggressive effort to make the euro conversion a boon to the economy. Nearly a third of Italy's \$900 billion

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Italy is at the center of the clean-money effort: Nearly a third of its economy is underground

n GDP is, by private-sector estimates, documented. The government says citizens have at least \$320 billion in savings abroad.

Treronti is hard at work on proposals for a partial tax amnesty on money earned legally and hidden abroad from authorities. The key feature of his plan will probably be a one-time tax of 3% to 3% on legal capital repatriated during the euro-conversion period. He also wants to raise the threshold for criminal penalties for tax evasion from \$91,000 to double or triple that amount, meaning fewer tax evaders who fess up will be subject to criminal charges. He's also working on a scheme to persuade underground businesses to come in out of the cold by offering them a partial tax amnesty and an initial reduction in employee social charges.

There's plenty of skepticism. Many Italians fear that even if the government lets them off lightly now, they'll find themselves on a list of confessed

tax dodgers who will get special scrutiny in the future. Moreover, many doubt the government will offer a good-enough deal to make it worth the risk.

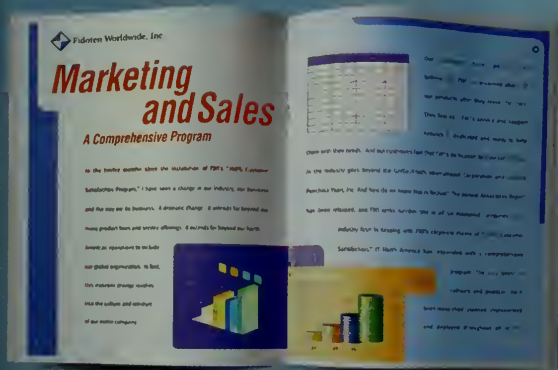
In Italy and elsewhere, however, the practical truth is that most tax evaders with offshore accounts won't be inclined to do their governments a favor by cooperating with the euro-conversion programs. They risk nothing by leaving money abroad, since banks will automatically convert deposits in euro-zone currencies into the new money when the clocks strike midnight on New Year's Eve. That will happen in Lugano, Switzerland, a favorite Italian tax haven, exactly as it will in Milan or Rome.

BUILDING BOOM. But Europe's economy may get a boost anyway. There's already evidence that Europeans with lots of cash at home have decided not to risk smuggling it across borders or bringing their nest eggs into the bank. Instead, they're investing the money in washing machines, refrigerators, cars, and houses.

In fact, says UBS Warburg economist Alison Cottrell, this is what's behind the construction boom in such places as the Spanish island of Majorca, a popular vacation spot for German tourists, where sea-view property prices have doubled in the past two years. Spain's Grupo Dragados, Italy's Buzzi Unicem, and other European building-material suppliers say that demand for their products has risen in recent months, despite the slowing economy.

That's good news for Europe. Consumer confidence and spending in the euro zone have stagnated since July. Long term, though, it will take more to legitimize Europe's underground economy. Once the blip of the conversion passes, Europeans will continue stashing away money abroad or hiding it beneath the floorboards until they can count on better returns and lower taxes in the formal economy.

By David Fairlamb in Frankfurt, with Gail Edmondson in Rome



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POLAND

THE WRONG GOVERNMENT AT THE WRONG TIME?

A socialist victory could speed the economic slide



STAGNANT: The EU slowdown has hit Poland with joblessness and slow growth

The star pupil. That was Poland's reputation in the years that followed the collapse of communism in Central Europe and the Soviet Union. Under the guidance of the Solidarity Movement and its heirs, Polish policymakers seemed to do everything right. They flung open the borders to foreign investment, shed price controls, auctioned off state properties, and enforced a tight-money policy to smother inflation. If the pain was immense, so was the payoff. Poland has turned into one of Europe's low-cost manufacturing centers and has emerged as a top candidate from Central Europe to enter the European Union first.

But the star pupil is now in danger of flunking. Welded to the West European economy, Poland is now feeling the full brunt of the slowdown in the EU as well as the impact of its central bank's tight monetary policy. Poland's growth will barely top 1% this quarter, unemployment is hovering at 16%, and with tax receipts down and spending up, the budget deficit keeps ballooning. Jittery investors have been dumping Polish securities, sinking the zloty and plunging the Warsaw Stock Exchange to four-year lows. Tomasz Kosobucki, president of Katowice-based Web portal Hoga, blames the economic mess for his com-

pany's lackluster share performance since its flotation in May. As if all this were not bad enough, Poland's cherished goal of joining the EU in 2004 appears at risk, as negotiations are running behind schedule.

The bleak picture could repeat itself throughout Central Europe, so what happens next in Poland will reveal a lot about the region's future. That's especially so now that Poles are just days away from voting in national elections, which former president Lech Walesa says are "the most significant since the collapse of communism." Most opinion polls point to a resounding defeat of the right-of-center Solidarity Election Action (AWS) and victory for the socialist Democratic Left Alliance (SLD), the heirs to the old Polish Communist Party. Its leader, Leszek Miller, 55, warns that the victor will need a solid majority to turn

the economy around. "[Poland needs a] strong government capable of real action," says the former member of the Communist Party Politburo.

Whether Miller has the right prescription to revive the ailing economy is an open question. Many business folk are skeptical. Their big fear is not return to communist-style rule but a regime that carries out a mishmash of socialist spending programs and essentially shelves reform, just when tough measures are needed. Companies still want to see more state companies privatized. Businesses also want a reduction in onerous social-security contributions, and they yearn for a labor code that will make it cheaper and easier to hire and fire workers. But first and foremost, business wants to see the budget deficit, which is heading for an unsustainable 11% of gross domestic product, brought under control. The deficit has dragged down the currency, which has shed 15% of its value against the euro over the past eight weeks.

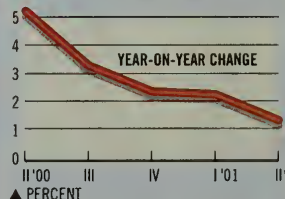
IMPORT TARIFFS? The SLD's vaguely worded proposal to cut the deficit without touching spending does not inspire much confidence. Analysts expect a hike in the value-added tax to generate more revenues. That could backfire by stifling consumer spending. Miller may also try to import tariffs on agricultural products and consumer goods, which could put up inflation and irk the EU.

Other SLD policies will undoubtedly unsettle foreign investors. Wieslaw Kaczmarek, an SLD member of Parliament who will likely be Treasury Minister, says he will prevent foreign banks and insurance companies from buying up more of Poland's financial sector. "Seventy percent is already in foreign hands," he says.

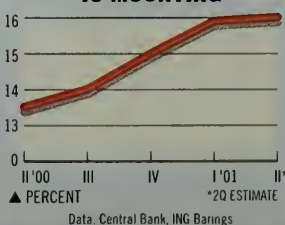
No doubt the SLD will feel pressure to be more pragmatic once it gets into office. It may tinker so with the labor code and it wants to foster growth in the small business sector. But if the world sinks deep into recession, Poland's old communists may yet discover the need to learn painful new lessons in reform.

By David Fairclough and Bogdan Turek
Warsaw

POLAND'S ECONOMY IS COOLING...



...AND UNEMPLOYMENT IS MOUNTING



Data: Central Bank, ING Barings

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A FED CHAIRMAN IN THE MAKING?

Does Treasury Under Secretary John Taylor have the stuff to succeed Greenspan?

Last January, Stanford University economist and Bush adviser John B. Taylor was considered a shoo-in for the top slot on the President's Council of Economic Advisers (CEA), a Cabinet-level position. But after talking it over with GOP *éminence grise* George Shultz, Taylor decided he would be better off taking a job as Treasury Under Secretary for international affairs.

from it," Shultz says. "He'll have to mess around with very operational, practical problems."

More important, if Taylor plays his cards right, he might even follow in Volcker's footsteps and become chairman of the Federal Reserve. Officially, 75-year-old Alan Greenspan's tenure is not up until June, 2004. But some of his friends think he'll step down before

low Greenspan's lead in keeping inflation in check without stifling economic growth.

What's not clear is whether Taylor, 54, has the political acumen and the Wall Street credibility for the Fed job. Although no political neophyte—he served as a member of the CEA under Bush's father and was chief economic adviser to Bob Dole during Dole's failed

bid for the Presidency—the mild-mannered Taylor has yet to prove his mettle in the rough-and-tumble world of Washington. And he's a relative unknown on Wall Street, outside of a small band of bank and brokerage-house economists who use his monetary rule to try to predict Fed rate moves.

"HE'S A GENERAL." All that is about to change. Taylor's new job puts him at the center of one of the most pressing issues facing the Administration: what to do about the faltering global economy. "He's not just a lieutenant," say his boss, Treasury Secretary Paul H. O'Neill. "He's a general in this encounter." How Taylor fares will make or break his career as a Washington policymaker and determine his chances of becoming Fed chairman.

THE TAYLOR RULE

How monetary policy should work

Developed in 1993, the Taylor rule is a relatively simple mathematical equation that links changes in interest rates to fluctuations in inflation and economic growth.

Under the rule, the Fed alters inflation-adjusted interest rates up or down depending on two factors:

whether the economy is operating above or below its potential and whether inflation is above or below a presumed 2% target.



To be sure, the CEA post ranked high in the Washington pecking order. But Shultz, a veteran of the Nixon, Ford, and Reagan Cabinets, knew how important—and influential—the Treasury could be. When Shultz headed the Treasury Dept. in the early 1970s, Paul Volcker had been his chief international trouble-shooter, and together they had helped revamp the global monetary system. "[Taylor will] learn a lot

that, once the economy has recovered from its current malaise.

Taylor, a top-flight monetary economist and former candidate for vice-chairman of the Fed during the first Bush Administration, would be on the short list of contenders to replace Greenspan. Fed policymakers already use his "Taylor rule"—linking interest-rate changes to the economy—in their deliberations. And Taylor could be counted on to fol-

low Greenspan's lead in keeping inflation in check without stifling economic growth. It's not an enviable assignment. The world economy may be on the verge of its first recession in nearly 30 years as the downturns in Europe, Japan, and the U.S. feed off one another. Emerging markets are jittery—despite big International Monetary Fund loans for Argentina and Turkey. And the once mighty dollar is looking shaky.

If that weren't enough, Taylor has to



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Government

Taylor is untested in Washington and mostly unknown on Wall Street—but not for long

contend with a boss whose painfully candid style has unnerved investors more than once. He must also cope with second-guessing from Bush's chief economic adviser, Lawrence B. Lindsey—an erstwhile rival for the Fed job.

At Stanford, Taylor won a reputation as a first-rate teacher—even going so far as to dress up as a raisin to demonstrate to an economics class how TV ads increased demands for the fruit. “He

puter models to forecast the economy. “He’s very smart. He’s very collegial. He’s a delight to work with,” says Greenspan.

So far, Taylor’s record as the nation’s top financial diplomat is mixed. Under gentle but persistent prodding from the U.S., the central banks in Europe and Japan have taken further steps to ease monetary policy. But even Taylor is doubtful that this will suffice. “There’s

a difference of opinion as to how he politely puts it. “In a few months, we’ll know more.”

Taylor has not yet come under fire for working with the Fed over the summer to put together an additional \$8 billion in financing for cash-strapped Argentina. Critics charge that Buenos Aires had already squandered billions of dollars in Fed assistance and did not deserve the extra money. They want the Treasury to send a message to investors that the big international bailouts put together by the Clinton Administration were a thing of the past. “We’ve just rescued the speculators,” comments longtime Taylor friend Allan H. Meltzer, a professor at Carnegie Mellon University who wrote the history of the Fed.

Taylor sympathizes with these concerns. Indeed, he once called for the abolishment of the IMF, contending that its bailouts encouraged excessive risk-taking by speculators and emerging market governments. But he argues that “you have to take steps as you go and be gradual about it. It’s not a good idea to be disruptive and make things worse.”

That’s the sort of hard-headed pragmatism that Shultz hopes Taylor will take away from his job as Treasury Under Secretary. He’ll need it if he ever lands in Alan Greenspan’s shoes.

By Rich Miller in Washington

IF NOT TAYLOR, WHO?

Besides Taylor, two other economists are frequently mentioned as candidates to succeed Fed Chairman Alan Greenspan

LAWRENCE B. LINDSEY As chief White House economic adviser, the 47-year-old Lindsey is a trusted confidante of the President and wields considerable influence within the Administration. A former Fed governor and economic consultant, he’s well known on Wall Street as an astute observer of the economy. But he has a deeply partisan streak that could make it difficult for him to win confirmation if the Senate remains in Democratic hands.



MICHAEL J. BOSKIN Currently a professor at Stanford, Boskin served as chief economist in Bush the elder’s White House. There he argued unsuccessfully for more aggressive action to combat the 1990–91 recession that eventually cost the Republicans the election. Along with Lindsey and Taylor, he played a leading role in fashioning the younger Bush’s economic policies during the campaign. Although respected for his academic research, Boskin, 55, is not considered to be in Taylor’s league as a monetary economist.

reminds me of Alan Greenspan,” says Martin Anderson, a fellow Stanford professor who has known the Fed chairman for more than three decades. “He’s very quiet, but he knows his subject backwards and forwards.”

MIXED RECORD. In fact, Greenspan and Taylor have known and liked each other since the early 1970s, when Taylor served under the monetary maestro at President Ford’s CEA. Greenspan was so impressed with Taylor that he hired him later at the Townsend-Greenspan consulting outfit after they both left government. There, Taylor helped Greenspan develop macroeconomic com-

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Cash Flow for Teen Tycoons

Hard lessons in fiscal fitness

BY KARLA TAYLOR

Some parents complain that their teenagers won't work. Others face the opposite problem: Their money-minded kids become wildly successful at baby-sitting or lawn mowing. In a matter of months, these small-time entrepreneurs have the cash to become big-time spenders. No longer dependent on the Bank of Mom & Dad, they're off to the mall, the video-game store, or the 7-Eleven to treat their pals to a round of Slurpees.

How do parents turn down the cash outflow when they no longer control the faucet? Teaching kids to manage money is never easy. And teen tycoons are at risk for what researchers call "premature affluence"—all the privileges of ready cash with none of the regular expenses. With no rent to pay and with no groceries to buy, my 14-year-old son, Elliott, sees nothing wrong with dropping \$70 of leaf-raking cash on a subscription to a British aviation magazine. Since time-pressed neighbors will pay \$35 a lawn or \$10 an hour for baby-sitting, the sums involved can be large. And with real adult responsibilities just a few years away, you don't have much time to teach your well-heeled child save-aholic habits.

SILENT TREATMENT. The first thing to remember: "The kids are right: It is their money," says Jayne A. Pearl, author of *Kids and Money: Giving Them the Savvy to Succeed Financially* (Bloomberg Press, 1999). But even the most entrepreneurial kids depend on parents to instill good fiscal habits. A survey of 12-to-17-year-olds by the GE Center for Financial Learning in Richmond, Va., found that 71% of kids say they learn about money from their parents—even though 47% say they

seldom or never discuss the issue. If you're among the silent near-majority, it's time for The Talk—not the one about sex, but about the financial facts of life. The Talk should cover the teenager's financial goals, why it's important to save, and how to be a smart consumer.

Especially when teens are earning their own cash, your job is to help. "Set goals—don't legislate," says Pearl. Maybe your 14-year-old dreams of buying his own car in two years. Don't just say: "You can't afford that." Instead, ask: "So how much would you have to save, at what percent interest, to get a Maserati you have in mind?"

Most planning focuses on a scheme for dividing the young workers' funds into immediate spending, short-term goals, and long-term saving. Some parents advocate allocating 40% for near-term goals, 25% to routine expenses, 10% to church or charities, and 25% to long-term savings. Short-term savings are crucial because they yield the rewards—a trip during spring break or an

PROBLEM Your teenager has money to burn but not a clue about expenses.

SOLUTION Set some expenses—entertainment, lunches, clothes, etc.—that she must cover out of earnings and allowance.

PROBLEM A 3% passbook rate offers much incentive to save.

SOLUTION Offer a "401(k)," with a 50%-to-75% match when your teen's savings reach a preset goal.



Conundrums for
High-Earning Teens



Things, and Full-Frontal Snogging. But when Shelley lost interest and wanted to return the book the next day, Stewart said no. "You have to make sure the consequences are their consequences," she says.

Some consequences you can't avoid. When your hard-working teen is socking away \$1,000 or more in a summer, how he saves can affect your taxes and college aid. Once the cash overflows the piggy bank, you have to decide whether to save in your child's name through a custodial account, or create an account in your name. Most parents use custodial accounts because interest earned by a teen suffers a smaller tax bite.

PENALTY. But that tack can put college aid at risk. Under the federal college-aid formula, if your child has \$1,000 saved in her name, she'll be required to contribute \$350 of it toward her freshman-year expenses—and her aid will be cut by \$350. The same \$1,000 in your name reduces aid by only \$56. The tension between giving her the responsibility of saving and maximizing financial aid prospects "does present a perplexing problem," says Judy Miller, a certified financial planner at College Solutions in Alameda, Calif. If you and your teen decide it's best to save in your name, then put the money in a separate account and have her do the bookkeeping.

Admittedly, saving for anything more than six months away offers about as much appeal to a 14-year-old as orthopedic shoes. "Deferred gratification is probably the hardest thing to teach," says Nicki Campbell, the mother of three teens in Columbus, Ohio. Campbell offers a sweetener: a 50% match, which her teens call "the 401(k)," for funds put in long-term savings.

Or you can try to replace the fun of spending with the thrill of investing. When his parents encouraged Michael Stahl, then a fourth-grader in Leawood, Kan., to invest a small gift of money in the company of his choice, his Atari stock quintupled in three months. Now 19 and the author of *Early to Rise: A Young Adult's Guide to Investing* (Silver Lake Publishing, 2000), Stahl advises teens to invest in stocks they can relate to—such as his stake in AMC Entertainment, a theater chain based in Kansas City, Mo.

Of course, investing's thrills can turn into chills. Danny Tobias, now 19, plowed his camp-counselor and busboy earnings into a global mutual fund and enjoyed two years of great returns—until global stocks sank. The losses were painful, but Danny's father, Benjamin Tobias, president of Tobias Financial Advisors in Plantation, Fla., figures they were a small price to pay for "a great lesson" about why you have to invest for the long term. After all, Danny has still got most of his principal—and a strong base, both financial and emotional, for mature affluence in the years ahead. ■



SHELLEY STEWART

Accepting the consequences:
This 14-year-old sold Beanie Babies and spent the proceeds on a pricey hardback book—which she found dull. But her mother refused to let her return it

er—those that make all that baby-sitting worth the effort. "Just be sure there's a pause between the income and the outgo," says Kate Kelly, mother of three girls and author of *The Complete Idiot's Guide to Parenting a Teenager* (Alpha Books, 1996).

To teach that earnings bring responsibilities, figure out how your child's income and allowance mesh with expenses. Perhaps your teen can take over paying for entertainment, school lunches, or clothes. Many parents give an annual back-to-school clothing allowance of, say, \$150 to cover everything except coats or shoes. The next Guess shirt comes out of her own pocket.

What if your teen's choices make you cringe? The purchase isn't immoral, illegal, or too objectionable, bite your tongue. Even small purchases can be learning experiences. Karen Stewart of University City, Mo., said nothing when her 14-year-old, Shelley—earned by baby-sitting and dealing in Beanie Babies—insisted on spending her money on a full-price hardback copy of the recent sequel to the teen hit book *Angus*,

PROBLEM Your teen sees his bank account as a hole: Money goes in but never comes out.

SOLUTION Encourage a short-term savings plan for bigger purchases to prove the value of gratification.

PROBLEM You cringe at the platform boots your teen's about to buy with her baby-sitting cash.

SOLUTION Apply the "one comment" rule. State your objection clearly and briefly, once. Tell her: "Save the receipt." Then shut up.

PROBLEM You tell your teen to sink or swim with his expenses—and he sinks.

SOLUTION Advance him funds for overlooked essentials, with a plan for repayment. But ignore those pleas to underwrite the next ski trip.

Give It the Old College Try with a 529 Plan

A tax-free—or close to it—way to save for schooling

BY ANNE TERGESEN

By this time next year, every state will offer a 529—which means you can shop around for low fees

If you want your child to attend college, remember this number: 529. Thanks to the recent tax legislation, state-sponsored college savings plans—known as 529 plans for the section of the tax code that created them—are, for most people, the best way to save for college.

The reason is simple: no federal taxes. Starting in January, the U.S. government will allow you to tap the money accumulated in a 529 plan tax-free. This is a big change from the past when earnings were taxed at the student's income-tax rate upon withdrawal. Several states have waived their own taxes on these accounts, and more—though not all—are expected to follow. One hitch: The money must be used for higher education or you will pay taxes and a penalty, typically 10% of earnings.

With a 529, you should be able to save enough to cover four years at a private college. The states don't manage your money. Instead, each has selected a professional to offer a handful of stock and bond funds. New Hampshire, for example, picked Fidelity Investments, while New York went with TIAA-CREF.

FREE TO ROAM. The best way to approach 529 investing is to start with your own state's program. This is important because your state may allow you to deduct

contributions to its plan from state income tax. Generally, deductions are hard to pass up, calculate your tax savings before opting for an out-of-state plan.

If your state's plan has high fees—1% of assets or more—or unappealing investment options, shop around. Already, 43 states offer 529 plans, with 50 expected to have one by this time next year. Going with an out-of-state plan is getting easier. In the past, some states levied taxes on withdrawals from out-of-state plans while exempting money in their own. But now many states are likely to give tax-free treatment to all 529s, says Joseph Hurley, whose Web site, Savingforcollege.com, compares the plans and gives contact information (as does www.businessweek.com/magazine/content/01_11/b3723116.htm).

Tax-free status makes a big difference. According to T. Rowe Price Associates, if you invest

\$5,000 a year in a 529 equity fund that earns an average annual return of 10%, you'll have \$287,704 after 28 years. In contrast, a taxpayer in the 28% bracket would have \$224,527.

After taxes in a regular brokerage account, you'd have \$250,157 in a custodial account, which exempts only the first \$750 in gains per year from taxes.

LOST SCHOLARSHIPS. Some other college savings options—the education Individual Retirement Account and state-sponsored plans that let you prepay tuition—are free from federal taxes, possibly state income taxes, too. But neither allows you to save as much as the \$200,000 permitted by many 529s. With a prepaid plan, you can save only as much as it costs to attend state school. And education IRA contributions are capped at \$2,000 a year starting in 2002—enough to pay for State U 18 years hence, not Harvard. So open an education IRA if you are eligible—income limits in 2002 are \$220,000 for couples and \$110,000 for singles. But establish a 529 account, as well.

The 529 plans do have drawbacks. Where education IRAs give you unlimited investment options, 529s offer only a few. And once you select an investment course, you can change it only by designating a new beneficiary or transferring the account into another state's plan. A year later, you can move the funds back to the original beneficiary or state plan. One way to ensure appropriate asset allocation over the years is to select an option that automatically shifts money from stocks to bonds as a child ages.

A successful 529 plan may reduce your child's ability to qualify for financial aid. If you save for seven or more years, though, the tax benefits of a 529 are likely to make up for any loss of aid, says K.C. Dempster, program development director at College Money, a financial-planning firm in Marlton, N.J.

The 529 savings plans aren't perfect. However, if you start putting money into one of them early on and then invest regularly, there's no better deal around. ■



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Using the Web to Teach Financial Facts of Life

Games can transform good sense into fun and games

Here's a tactic for teaching your kids financial responsibility: Make their fascination—and facility—with the Internet work for you. Personal-finance Web sites for kids that teach everything from budgeting to managing a portfolio have become plentiful on the Net. Many are so easy to use that any parent or child with a modicum of computer literacy can take advantage of them. By using games, quizzes, and other interactive material, the best sites can hold the attention of a child who might not otherwise be willing to focus on financial topics.

the journey, kids make financial decisions, starting with choosing a job—at the oxygen-canning or hair-piece-harvesting factory.

The game challenges them to make choices, such as where to live and what transportation to use, that won't exceed their salaries. As decisions are made, the column on the left-hand side of the screen fills in the numbers showing whether the choices are breaking the budget. Along the way, young learners practice writing a check and become conversant with terms such as mortgage, direct deposit, and rate of return. The site also offers activities and lessons that complement the game



The Jump\$tart Coalition for Personal Financial Literacy, geared to youths, offers a good starting point (table). Check out its site to get an overview of how you can proceed with your child's financial education, whether she is 7 or 17. For instance, the site has a section on the "12 principles that every young person should know" about money. Select the ones—for example, "don't borrow what you can't repay"—you think are most relevant to your family and appropriate for your child's age. It also has links to about 60 other financial sites you can explore with your kids.

The site has an "Investing for Kids" link that offers the ThinkQuest Stock Game, which you can play with your 10-year-old but your 15-year-old can probably play alone. The game lets your child create, trade, and monitor an imagined \$100,000 stock portfolio. Links to such sources as www.quicken.com can assist players in making their stock picks. Another section offers a "Reality Check" quiz aimed at older teens who are about to leave home.

HAIRY TASK. For a more whimsical approach, go to the site created by Firststar Bank, a subsidiary of Minneapolis-based U.S. Bancorp, for middle- and high-school kids. Enlivened by animated, neon-colored graphics, the site takes viewers on a fantasy trip to the planet of Knab. On

Your child can do anything from playing the market to managing a portfolio to budgeting for that Lear Jet he has his heart set on

and that parents can use to work with their kids. Just go to "Educational Stuff" and click on "Activity Sheets."

Sites with question-and-answer games can help parents determine how much their teens know about money management. At www.themint.org, which is sponsored by Northwestern Mutual Life Insurance and the private, nonprofit National Council on Economic Education, a true-or-false stock market quiz features such statements as "Only rich people invest in the stock market" and "The U.S. government sells most of the stocks on the stock market." It then goes on to provide clear discussions on the topics. Another section, "Where to Spend \$1,000," leads to a primer on different types of securities and potential yields. A downside: The graphics are plain.

The National Endowment for Financial Education (www.nrtbonline.org), a Denver-based nonprofit financial-education organization, is set to sponsor a new site for teens. Slated to be up and running soon, the site will feature a section in which a chatty "Madame Moolah" will dispense advice on spending. Teens can also read about youthful role models of responsible financial behavior. For example, a 31-year-old singer and cello player who works as a music librarian describes his education and how his mother inspired him. The site's content, which will change every quarter, also includes games and articles on money matters.

For parents of sixth- to eighth-graders who are looking for a comprehensive curriculum, American

Century Investments, a Kansas City (Mo.) financial-services company, has launched www.tipsforkids.com. You can download a 168-page study guide that covers everything from the history of money to investing. But the material was created for the classroom, so it's most appropriate for parents committed to providing a structured study program. Once you get on the site, click

"apply for grants" to get a password and download material.

If you or your teen wants something more practical than conceptual, check out the site sponsored by the Canadian Bankers Assn. It can guide you on how to set up a budget to meet a financial goal, whether it's one, three, or eight years away. The site focuses heavily on banking terms such as the different types of accounts, and how the banking system works. Be aware that some references relate to the Canadian banking and currency system, not that of the U.S.

For a handy savings calculator, go to the Washington-based American Savings Education Council (www.asec.org). It can help you develop a savings strategy if he wants to buy a computer game or finance a trip to Disneyland. **FIRST SWIM.** If your focus is teaching your teen about investing, you have several sites to choose from. The Madison Heights (Mich.)-based National Association of Investors (www.betterinvesting.com), which sponsors investment clubs, offers information on youth memberships and how to start a club. Boston-based Liberty Mutual Financial boasts colorful animated graphics, a "library" on financial issues, and interactive

games that explain basic terms such as risk, bull, and bear. The site also features a question-and-answer section on money issues for parents and kids. While the graphics are attractive, the text is presented in a small window so it can be hard to read.

Finally, if you want a low-cost way to encourage your child to invest, go to sharebuilder.com, where you can purchase even fractional shares of stocks by dollar amounts, for \$3 per transaction or \$8 a month. A helpful frequently-asked-questions section provides guidance on how to manage your account.

Instilling financial responsibility in your kids can be difficult when you're competing with images of \$100 tennis shoes, \$150 designer jeans, and \$300 video game players. The Net offers an attractive medium to get your message across.



Clicks for Kids: Learning About Money

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COMMENTS

AMERICAN CENTURY
tipsforkids.com

Download a 168-page study guide for sixth- to eighth-graders. Material was developed for the classroom.

CANADIAN BANKERS ASSN.
yourmoney.cba.ca

Older teens who need a reality check on the cost of life beyond high school can set financial goals and create budgets for one year, three years, and eight years out.

FIRSTSTAR BANK
escapefromknab.com

Glitzy graphics and a fantastical story about how to live on a budget on the imaginary planet of Knab should hold the interest of restless preteens.

JUMPSTART COALITION
jumpstart.org

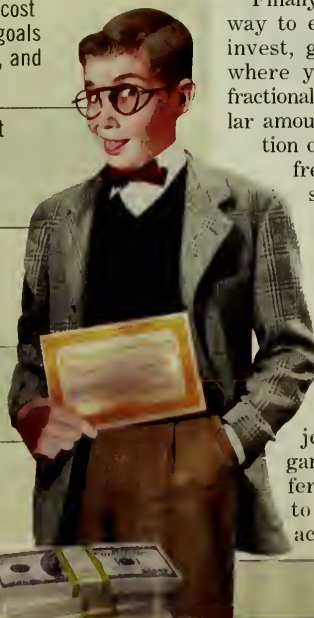
Money-management principles for your family, with links to some 60 other sites. Click on "investing for kids" to sign up for twice investing.

LIBERTY FINANCIAL
younginvestor.com

Find something for everybody: a library of financial information; a lively, colorful game room; and question-and-answer.

NATIONAL ENDOWMENT FOR FINANCIAL EDUCATION
nrtbonline.org

Expected to be launched shortly, this "youth to youth" site boasts a teen advisory board to explore real-life issues.



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BALMY WEATHER AHEAD FOR PALMS?



BY ROBERT BARKER

rb@businessweek.com

The markets have battered Handspring and Palm, but both companies have underlying value—and both are tantalizing as targets

The term "Palm Economy" down in Florida where I live might mean tourism, or maybe even the brisk trade in palmetto berries, craved for their extract by prostatitis sufferers. In Silicon Valley, the Palm Economy is a whole other thing: a network of software, computer, and telecom companies that rely on Palm OS, the leading operating system for handheld computers. Right now, it's craving relief of its own.

Instead of any herbal remedy, what the Palm Economy needs is a quick hit of Prozac. After greeting the two pure-play stocks, Palm and Handspring, first with enthusiasm and then with manic abandon, investors today could hardly be more depressed (table). Last November, the sum of the two companies' market values nearly hit \$50 billion. Lately, the market says these businesses aren't worth \$2 billion.

Investors: Get a grip! Yes, the Palm Economy is uncertain. (Will Palm produce a badly needed new version of its operating system next year, as planned?) Yes, it faces anyone's last choice of competitor. (Microsoft just released a new version of its rival Pocket PC software.) And yes, Palm and Handspring, an independent licensee of the Palm OS, both have been losing money. (Wall Street foresees current fiscal-year losses totaling \$135 million on sales of \$1.9 billion.)

So the next couple of quarters don't figure to be pretty. But the way I see it, this is already reflected in the prices of Palm, under \$3 a share, and Handspring, near \$2.30. What's not reflected are a few simple realities that suggest the companies will crawl out of today's slough of despond:

■ **New customers, products, profits.** For all the panic about Palm, you would think its base of clients is shrinking. Instead, it's expanding beyond yuppie workaholics to new groups, such as this fall's freshman class at the University of South Dakota. USD gave each new student the latest Palm, a \$400 m500 model, and placed infrared ports around campus where they can link to e-mail, the Web, and updated class information. Upperclassmen, not included in the bounty, are envious. One hit up freshman Chelsea Tripp to buy her Palm at a small discount. Her re-

sponse? "No way," she told me. "It's really cool." Handspring expects this year to announce wireless models, and CEO Donna Dubinsky is posting a profit in the June quarter of fiscal 2002. As for Palm, after clearing inventories by cutting costs, it is expecting fresh operating profits in its current quarter, ending November.

■ **Balance-sheet fortitude.** We're not talking other Lucent Technologies-Teetering-on-a-Cliff Edge here. Neither Palm nor Handspring is burdened by a penny of long-term debt. Each has ample cash—Palm, at last report, had 90¢ a share in cash and short-term investments; Handspring, 94¢ a share. In other words, liquid and not just hope, are supporting these stock prices. The companies strive for profitability.

■ **The value of dominance.** If these stocks turn up soon, it's a fair bet someone will



CAMPUS CHIC
Palms are "in" at South Dakota

along to buy one or both companies. Microsoft's Pocket PC software is a questionably taking market share. The Palm OS now runs more than 16 million

devices around the world, and in this year's first half, Palm and Handspring still took 83% of unit sales, according to NPD Intellect. Palm remains synonymous with handheld computing.

Despite this sway in the marketplace of minds of consumers, the total stock market value of Palm and Handspring now comes to less than one-tenth of what it was a few years ago. Not counting the value on its balance sheet, Handspring's underlying business sells for half its \$340 million in sales, a tempting target. Palm, with its control of—and licensing revenue from—Palm OS, is even more tantalizing. In a recent reorganization, Palm split itself into discrete hardware and software units. It did not indicate a future asset sale or division into separate public companies. But such moves would be a fast way to uncover Palm's value.

Whether a deal eventually will save investors in the Palm Economy, I don't know. But chronic depressives could miss that the balance of risk and reward at last is running their way.

Bipolar Disorder

Data: Company reports, BusinessWeek

	MARKET VALUE MILLIONS		
	PALM	HANDSPRING	COMBINED
AT INITIAL PUBLIC OFFERINGS*	\$21,314	\$2,505	\$23,819
NOVEMBER, 2000	38,128	11,738	49,866
NOW	1,611	300	1,911

*Palm's IPO was in March, 2000; Handspring's was in June, 2000

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With the heinous Sept. 11 attack on America, worldwide fear about security has heightened. Predictably, companies that provide protection against terrorists are back on the Street's radar screen. One such outfit is little-known Armor Holdings (AH), which has a growth story—with a takeover twist.

Armor, a big maker of security gear, also offers security-planning and risk-management services to 60 heads of state and hundreds of executives in 80 countries. Its services are designed to prevent kidnappings, assaults, and terrorist attacks. In addition, the company puts armor on vehicles for clients such as the State Dept., the U.N., and the World Bank.

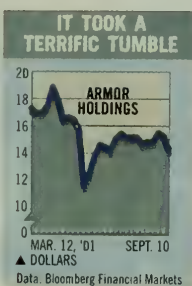
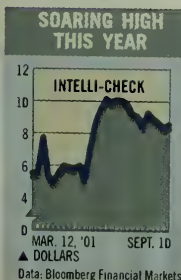
Its stock has been a winner—shooting up from 8 in April, 2000, to 19 a year later. But it tumbled to 11 on May 21, 2001, when Armor announced a restructuring charge related to the purchase of Kroll's security unit. The stock has since risen to 14. The acquisition should hike Armor's annual sales by 50%, notes Charles LaLoggia, editor of *The Superstock Investor* in Rochester, N.Y. The stock's drop was an opportunity to buy the stock on the cheap, he says.

The security business has been consolidating. LaLoggia thinks Sweden's Securitas, which in the past two years has acquired two U.S. companies—Pinkerton's and Burns Security—could go after Armor, too. But Tyco International may beat Securitas to the draw, he adds. Armor is worth 25 in a buyout, says LaLoggia.

Bear Stearns analyst Peter Barry, who rates Armor a buy, sees earnings of 91¢ a share in 2001 and \$1.25 in 2002, up from 86¢ in 2000.

A GIMLET EYE FOR FAKE I.D.

Another small company with few Street followers that is bound to grab investor attention is Intelli-Check (IDN), whose patented I.D.-Check software detects fake driver's licenses, fake military papers, and the like. Intelli-Check's customers include the Pentagon and Sensormatic Electronics, the leading supplier of security systems to retailers and mass merchandisers. Bart Blout, who heads Sawtooth Capital Management, which has accumulated 335,000 shares of Intelli-Check, says that in view of the terrorist attacks, document verification will become a necessary tool in eliminating identity fraud—and will be



sought out by airports, banks, and retailers. The growing menace of identity theft is costing businesses some \$25 billion a year, says Blout. Intelli-Check's technology, he notes, reads and validates the information encoded on the magnetic stripes and bar codes embedded in drivers' licenses in 40 states in the U.S. Intelli-Check expects the other states to sign up, too.

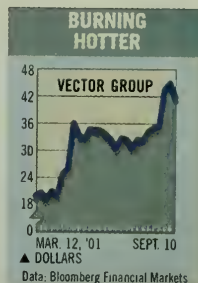
John Bendall of Hermitage Capital expects Intelli-Check's software to make major inroads this year into supermarket and drugstore chains and department stores. He expects sales of \$10 million and earnings of 4¢ a share this year and sales of \$30 million and earnings of 45¢ a share in 2002. He expects the stock, which has more than doubled—from 3.70 a share in March to 8.60 on Sept. 10—to hit 30 this year.

WILL 'SAFER' SMOKES LIGHT UP LIGGETT?

In two weeks, smokers will get a chance to try a cigarette with reduced carcinogens, its makers claim. Vector Group (VRG), which owns cigarette maker Liggett Group, will be producing 20 million Omni cigarettes a day to launch the product nationwide. By the end of 2001, Vector's Durham (N.C.) plant will have rolled 1.5 billion cigarettes, worth about \$200 million in sales. When this column first mentioned Vector in May, it was trading at 33. It's now at 42.

One big bull on Vector is financier Carl Icahn: He is convinced that Omni, along with Omni Nicotine Free—a version to be introduced in January—will light a fire under Vector's earnings. Icahn, who has raised his stake in Vector from 16% to 21.5%, says Vector will soon be providing big increases to its bottom line. The Omni Nicotine Free cigarettes use patented genetically altered tobacco seedlings that block out nicotine. Icahn believes the two new brands should snag 1% of the market in the first year. It could triple or double thereafter, he adds.

Vector Chairman and CEO Bennett LeBow says the company will seek approval from the Food & Drug Administration to market Omni as a "safe" product. The ads launching Omni won't make health claims, just say it has "reduced carcinogens"—referring, of course, to the lung-cancer risk. The Omni cigarettes, he says, look and taste just like premium-quality cigarettes. Donald Trott of Jefferies, who rates the stock a buy, sees Vector earning 88¢ a share in 2001 and \$3.30 in 2002.



BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:10 p.m. EST on CNNfn's *The Money Gang*.

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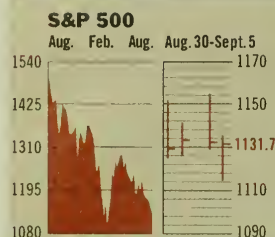
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Stocks



COMMENTARY

Equities fell in an abbreviated week of trading following the terrorist attack on the U.S. But in Europe, where bourses remained open, the major stock indexes swooned on Sept. 11 and continued their descent the next day, to 52-week lows, before recovering strongly later in the session. For the week, the London FT-SE and the Frankfurt DAX fell 8.2% and 14.1%, respectively.

Data: Bloomberg Financial Markets
Bridge Information Systems, Inc.

U.S. MARKETS

	Sept. 10	Week	Year to date	Last 12 months
S&P 500	1092.5	-3.5	-17.2	-26.3
Dow Jones Industrials	9605.5	-4.3	-11.0	-14.5
Nasdaq Composite	1695.4	-3.6	-31.4	-56.0
S&P MidCap 400	467.2	-3.9	-9.6	-13.9
S&P SmallCap 600	210.3	-5.0	-4.2	-5.2
Wilshire 5000	10,104.4	-3.5	-17.0	-27.5

SECTORS

	Sept. 10	Week	Year to date	Last 12 months
BusinessWeek 50*	725.3	-3.2	-25.2	-41.9
BusinessWeek Info Tech 100**	348.5	-3.8	-38.4	-61.4
S&P/BARRA Growth	551.2	-3.3	-19.8	-36.3
S&P/BARRA Value	541.7	-3.6	-14.8	-15.2
S&P Energy	852.4	-0.6	-8.5	-9.5
S&P Financials	138.9	-3.7	-15.7	-15.2
S&P REIT	92.5	-2.3	5.2	6.2
S&P Transportation	654.2	-4.5	-6.2	11.6
S&P Utilities	274.7	-1.0	-21.6	-18.2
GSTI Internet	87.6	-0.3	-51.8	-80.3
PSE Technology	586.3	-3.9	-28.0	-45.1

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Metal & Glass Containers	15.8	Engineering & Constr. 89.5
Engineering & Constr.	11.5	Tobacco 62.3
Cosmetics	10.8	Toys 57.9
Tobacco	8.9	Pollution Control 49.7
Soft Drinks	6.6	Hospital Management 41.3

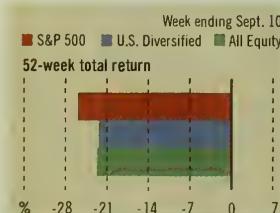
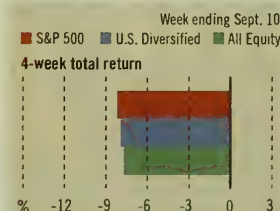
EQUITY FUND CATEGORIES

4-week total return %	52-week total return %
Leaders	Leaders
Precious Metals -0.9	Real Estate 9.9
Natural Resources -1.3	Precious Metals 8.1
Health -2.3	Small-cap Value 7.7
Real Estate -2.8	Mid-cap Value 6.6
Laggards	Laggards
Technology -17.5	Technology -61.1
Communications -14.6	Communications -56.6
Latin America -11.9	Japan -42.8
Mid-cap Growth -10.0	Mid-cap Growth -39.8

EQUITY FUNDS

4-week total return %	52-week total return %
Leaders	Leaders
ProFunds UltraShort OTC 41.8	Potomac Internet Short 235.4
Rydex Dynamic Vent. 100 41.6	Rydex Dynamic Vent. 100 174.4
Apex Mid Cap Growth 25.2	ProFunds UltraShort OTC 164.8
Potomac Internet Short 24.4	Rydex Arkto Investor 105.2
Laggards	Laggards
ProFunds UltraOTC Inv. -33.0	Hudson Investors -95.2
Berkshire Focus -29.3	ProFunds UltraOTC Inv. -91.4
Black Oak Emerging Tech. -29.2	Jacob Internet -86.3
Berkshire Technology -29.0	Berkshire Focus -85.7

Mutual Funds



Data: Standard & Poor's

GLOBAL MARKETS

	Sept. 12	Week	Year to date
S&P Euro Plus (U.S. Dollar)	959.0	-8.3	-3.3
London (FT-SE 100)	4882.1	-8.2	-2.1
Paris (CAC 40)	4114.3	-10.0	-3.0
Frankfurt (DAX)	4335.2	-14.1	-3.0
Tokyo (NIKKEI 225)	9610.1	-14.1	-3.0
Hong Kong (Hang Seng)	9493.6	-13.2	-3.0
Toronto (TSE 300)	7048.8	-5.5	-2.1
Mexico City (IPC)	5531.0	-9.2	-1.1

FUNDAMENTALS

	Sept. 10	Wk. ago
S&P 500 Dividend Yield	1.42%	1.37%
S&P 500 P/E Ratio (Trailing 12 mos.)	30.1	31.3
S&P 500 P/E Ratio (Next 12 mos.)*	19.5	20.2
First Call Earnings Revision*	-2.45%	-2.40%

*First Call Corp.

TECHNICAL INDICATORS

	Sept. 10	Wk. ago
S&P 500 200-day average	1246.4	1251.5
Stocks above 200-day average	51.0%	59.0%
Options: Put/call ratio	0.89	0.88
Insiders: Vickers Sell/buy ratio	2.57	2.75

WORST-PERFORMING GROUPS

	Last month %
Specialty Appar. Retailers -31.0	Communications Equip. -22.8
Communications Equip. -22.8	Computer Systems -21.4
Personal Loans -21.4	Semiconductors -21.3
Entertainment -21.3	Instrumentation -20.4
Automobiles -20.4	Oil & Gas Drilling

Interest Rates

KEY RATES	Sept. 10	Week ago
MONEY MARKET FUNDS	3.27%	3.32%
90-DAY TREASURY BILLS	3.26	3.41
1-YEAR TREASURY BILLS	3.31	3.47
10-YEAR TREASURY NOTES	4.84	4.97
30-YEAR TREASURY BONDS	5.43	5.48
30-YEAR FIXED MORTGAGE†	6.89	6.89

†Barr'sQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 31% federal tax rate.

	10-yr. bond
GENERAL OBLIGATIONS	4.08%
TAXABLE EQUIVALENT	5.91
INSURED REVENUE BONDS	4.23
TAXABLE EQUIVALENT	6.13

THE WEEK AHEAD

BUSINESS INVENTORIES Monday, Sept. 17, 8:30 a.m. EDT ► Inventory levels during July probably declined for the sixth consecutive month, by 0.4%, after falling 0.4% in June. That's according to the median forecast of economists surveyed by Standard & Poor's MMS, a division of The McGraw-Hill Companies.

INTERNATIONAL TRADE Monday, Sept. 17, 8:30 a.m. EDT ► The July trade deficit is expected to be \$29.1 billion, slightly less than the June deficit of \$29.4 bil-

lion. While both imports and exports are expected to have shrunk in July, imports likely fell by a larger amount.

CONSUMER PRICE INDEX Tuesday, Sept. 18, 8:30 a.m. EDT ► Based on the S&P MMS survey, consumer prices for goods and services probably rose 0.2% in August after a rare, energy-driven decline of 0.3% in July. Excluding the volatile food and energy components, prices likely increased by a similar 0.2%, after posting a 0.2% gain in July.

NEW RESIDENTIAL CONSTRUCTION Thursday, Sept. 20, 8:30 a.m. EDT ► Housing starts likely fell to an annual rate of 1.0 million in August, from 1.67 million in July.

FEDERAL BUDGET Friday, Sept. 21, 8:30 a.m. EDT ► The U.S. Treasury is expected to report an August deficit of \$50.5 billion after reporting a July surplus of \$1.0 billion and a deficit of \$10.4 billion in August. The sharp decline is due to President George W. Bush's tax cuts totaling \$40 billion.

Mar.

Sept.

Daily: Sept. 6-12

775

750

725.3

700

675

fell 3.2% this week. Along with the usual tech suspects that have dominated decliners through-
was specialty retailer Bed Bath & Beyond, which lost 15.4% of its value. Only nine stocks, many
-related or former utilities, managed to stay out of the loss column; the best showing came from
ces, up 3.1%, followed by Baby Bell SBC Communications, which added 2.8% for the week.

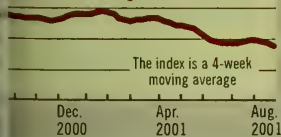
COMPANY PERFORMANCE

Company	% change		Rank	Company	% change	
	Week	Since 3/1/01			Week	Since 3/1/01
International	-4.6	-12.6	26	Verizon Communications	1.7	4.7
Ko Petroleum	0.9	-15.8	27	Citigroup	-6.9	-12.7
	-5.3	-34.8	28	Sun Microsystems	-3.2	-48.7
	-6.4	-16.2	29	Merck	-2.4	-17.1
Materials	-4.8	-11.7	30	El Paso	0.4	-29.6
an Financial	-9.0	-46.8	31	Altera	-6.5	3.3
ntal Petroleum	-1.2	17.3	32	Marsh & McLennan	-5.3	-17.5
	2.1	-18.9	33	Household International	-1.6	-3.6
cGee	-1.1	-7.7	34	Chevron	0.3	5.6
	-5.1	-46.4	35	SBC Communications	2.8	-4.5
n Brothers Holdings	-5.6	-9.1	36	Mercury Interactive	-2.5	-59.5
	-3.8	-67.5	37	AOL Time Warner	-6.4	-21.8
	-5.6	-46.9	38	Washington Mutual	-3.0	4.0
Laboratories	-0.8	10.9	39	General Dynamics	-2.1	13.2
oston Financial	-4.3	-14.8	40	Comcast	-6.9	-20.6
Technology	-11.8	-11.5	41	Morgan Stanley Dean Witter	-5.4	-23.1
	-4.7	-12.4	42	Tellabs	-3.3	-74.7
la Hess	-1.6	6.2	43	Exxon Mobil	0.0	1.3
energy	1.2	-4.5	44	Scientific-Atlanta	-7.2	-61.8
lecommunications	-13.0	-68.6	45	U.S. Bancorp	-1.9	2.1
One Financial	-4.0	-9.7	46	Paychex	-9.9	-19.9
Petroleum	-1.1	9.5	47	Merrill Lynch	-8.6	-21.9
Devices	-5.5	1.7	48	Bed Bath & Beyond	-15.4	-2.8
sources	3.1	-25.0	49	Texas Instruments	-7.2	-11.7
al Health	-5.2	4.9	50	Teradyne	-5.6	-7.8

Production Index

Change from last week: -0.5%
Change from last year: -4.9%

TRIAL OUTPUT Aug. 25=167.5 1992=100



on index continued to decline over the lat-
re calculation of the four-week moving av-
index slipped to 165.9, from 166.6. After
ustments, autos fell sharply for the week
entire month of August, with light-vehicle
d down 5.9% from a year ago by Ward's.
, and electric-power production were also
crude-oil refining, truck assemblies, and
raffic were all higher.

each of the index components is at www.business-week.com
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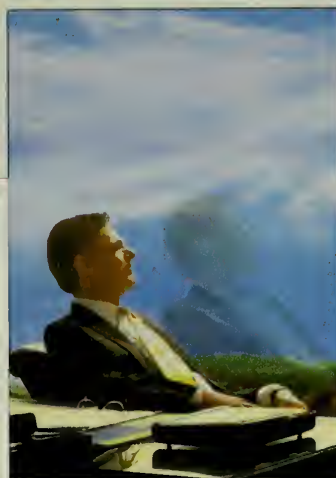
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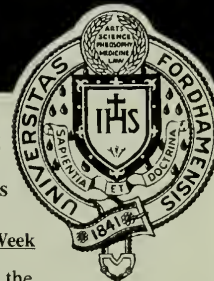
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WHAT MUST BE DONE

It was a day like no other in U.S. history. Sept. 11, 2001, marked the end of American global innocence, the probable onset of real recession, and perhaps even the fading of the country's anything-is-possible economic exuberance. The comfort of living safely far from danger across deep oceans may now be over. A devastating terrorist attack has hit at the heart of the nation's economic and military power: the World Trade Center near Wall Street in New York City and the Pentagon in Washington, D.C., just miles from the White House. A nation that entered the 21st century confident and optimistic about the future has seen that future altered.

Americans are used to seeing images of carnage, chaos, and death on TV, but in faraway Sarajevo or Beirut, not at home. A country reeling from unexpected economic decline now must cope with mad terrorism from the sky. Growing financial uncertainty is compounded by increasing worries about personal and family safety (page 32).

These twin blows to the economy and national security will seriously shake the nation's confidence. In the months ahead, they threaten to throw the U.S. into despair and recession. If fear and uncertainty prevail, how can people be expected to spend and invest for the future? If hijackers can steal commercial jets and crash them into high-profile, trophy buildings, how safe can people feel to fly—or even work in ordinary skyscrapers? Federal Reserve Chairman Alan Greenspan said in the 1998 financial crisis that “when events become too complex and move too rapidly, human beings become demonstrably less able to cope.” He’s right.

The job immediately ahead for the Bush Administration and the Federal Reserve is clear: They must address this national crisis and restore confidence as quickly as possible. They must reassure the U.S. and the world that they will deal with the damage, manage the threat, and bring the country to a safe harbor. More than just America's economic prosperity is at stake: The whole concept of a free, democratic, international society built on an open global economy is under attack. This fight cannot be lost.

This is what should be done:

Economic Management. The Fed must flood the economic zone with liquidity as quickly as possible. It has already announced it will keep its discount window open to any financial institution that needs it. It must also stand ready to make markets where none exist, bolster the dollar, and coordinate measures with other central banks. The European Central Bank in particular must end its hesitant and confusing behavior and lower interest rates. This is not the time to worry about inflation. Greenspan is an experienced hand at this drill, and he is performing well in instilling confidence in the financial markets.

Presidential Leadership. President Bush must do the same in the political sphere. Uncomfortable showing emotions publicly, stiff before a TV camera, the unseasoned President must find it within himself to project an image of caring healer and fierce protector to the people of America. He

must also engage internationally. There is no way the U.S. can combat terrorism without the support of overseas allies in Europe and the Middle East. Bush's unilateralist worldview reinforced by his close advisers, cannot work in a world where global cooperation is necessary to battle global terrorism. A President who simply walks away from issues considered important by allies, such as global warming, undermines their willingness to help when the chips are really down. Europe must do its part. France and Germany have consistently undermined U.S. efforts to contain terrorism in the Middle East by, in effect, trading with the enemy. And moderate Arab governments have continually allowed extremists to inflame anti-Israeli and anti-American passions.

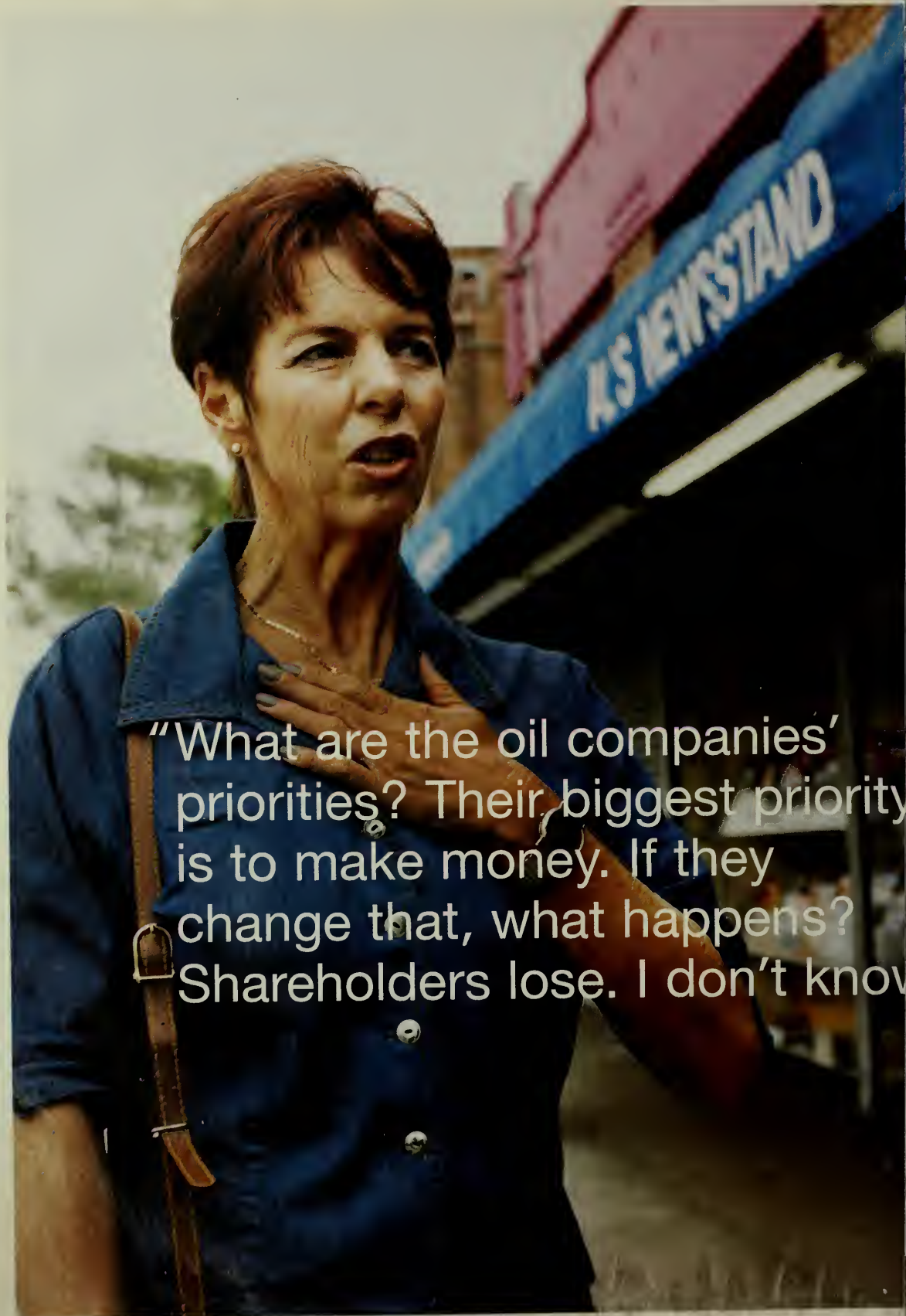
Washington Consensus. The partisan debate over defense in Congress should end. America's vulnerability to terrorism bent on destruction is revealed in all its dark hours. Discussions about strategy and tactics are about to repeat disagreements over funding levels and Social Security “lock boxes,” as they should. The failure of the nation's huge intelligence apparatus is profoundly disturbing. Suddenly, a missile threat from “rogue states” seems quite real. And the need to field a new army of spies and intelligence agents to track down and destroy terrorism is clear. All this will require higher defense spending and new budgetary priorities.

Corporate Leadership. Chief executives should play a leadership role in this time of national trauma. Around the country, people will soon be grieving for loved ones lost on hijacked planes or in the destruction of the World Trade Center twin towers. Most of the dead were working when tragedy struck. Chief executives who come forward to offer support and counseling to suffering employees will generate long-lasting loyalty. CEOs and Wall Street should try to place employment and the short-term bottom line in context during this difficult hour and realize that as the business cycle turns—and it will—with rates falling and the government spending more—profits will return. In that way, companies can help maintain the fabric of America in this period of economic and political crisis.

How the U.S. fights terrorism may well turn out to be even more important than the will to fight it. Government electronic surveillance and intrusion into individual private lives may be necessary, but it could chill the freedom so essential for a creative, iconoclastic entrepreneurial society to prosper. Issues of encryption and wiretapping have to be handled intelligently. It appears that a new trade-off between such freedom and safety is in order. But it is the most delicate of balances on which the future depends.

It is easy to exaggerate how different America will be after this attack. After all, this is not the first time tragedy struck the nation. But as the military pulls its dead out of the Pentagon and firefighters and police search for bodies in New York while mourning their own losses, it is hard to believe America will ever be quite the same again. The shape of the new millennium is finally revealed, and it is sobering to be-

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"What are the oil companies' priorities? Their biggest priority is to make money. If they change that, what happens? Shareholders lose. I don't know



BusinessWeek

OBER 1, 2001

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RETHINKING THE ECONOMY



The U.S. must now deal with urgent new priorities: Defending the homeland. Fortifying the financial system and critical industries. Dealing with recession. Strengthening the social safety net. All this means a more activist government, higher defense spending, and budget deficits. Fiscal and monetary stimulus is on the way, but brace for tough times ahead.

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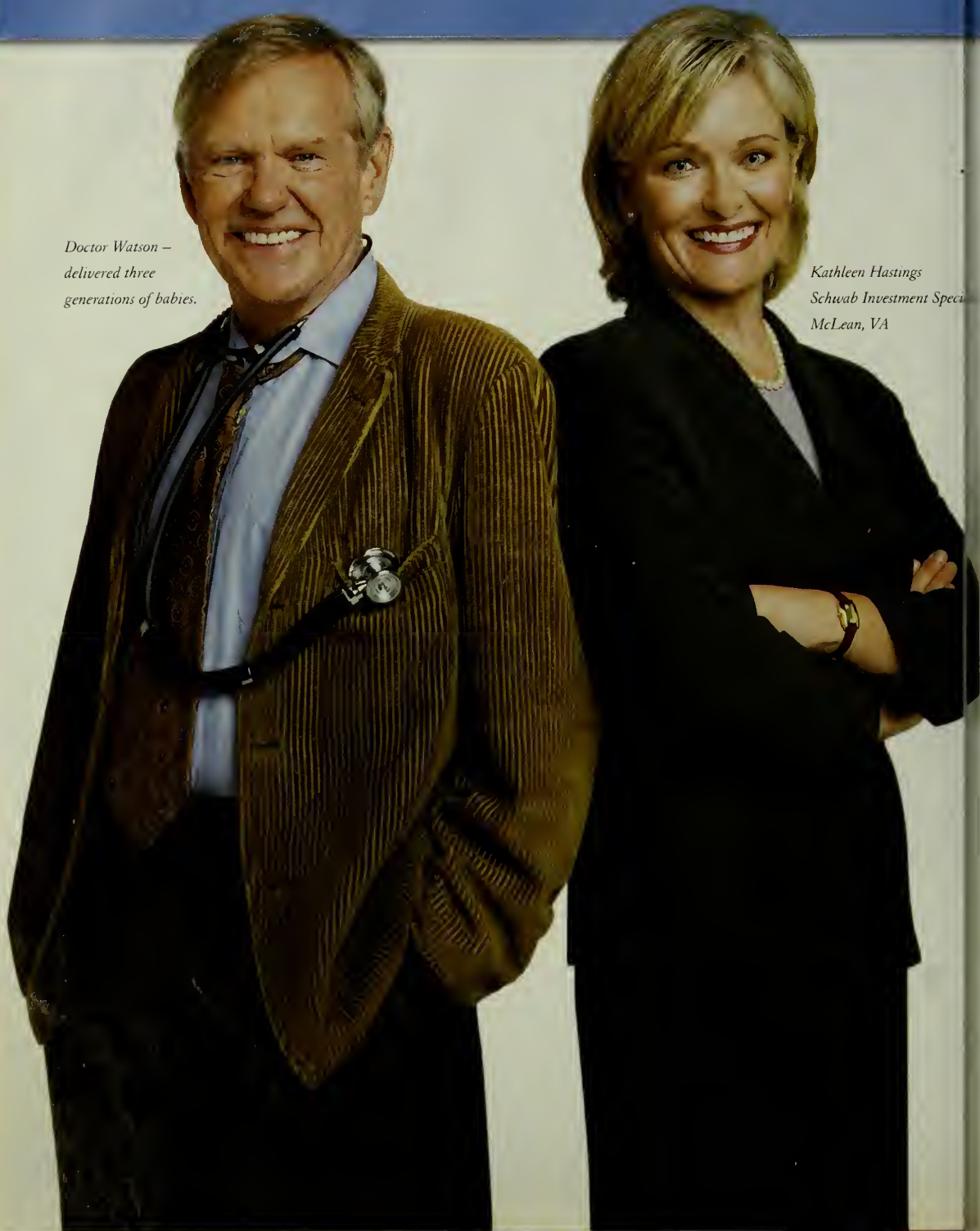


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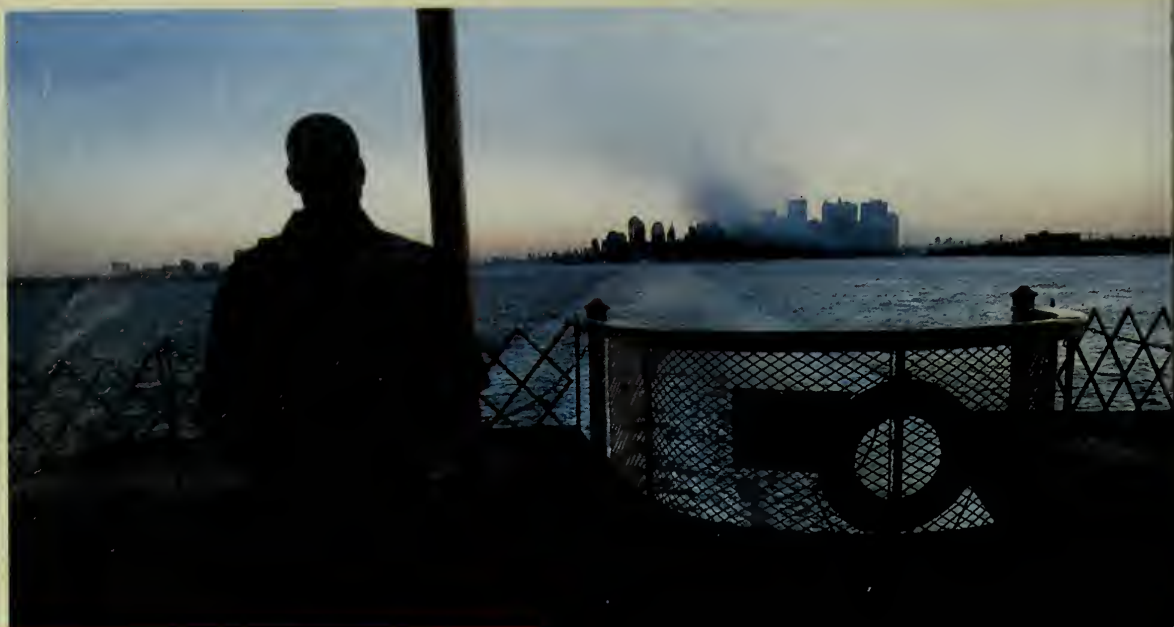
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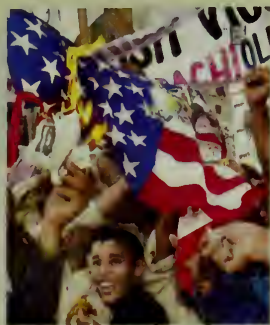
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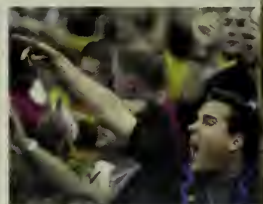
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THINK YOU CAN DO A BETTER job of intelligence-gathering than those we have on the job now? Lots of people do. Applications to the Central Intelligence Agency have jumped fivefold, from 500 or 600 a week to 3,000 since the terrorist attacks on Sept. 11, the agency reports. The CIA, after considerable downsizing

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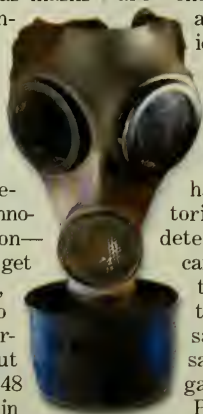
during the mid-'90s, embarked on a hiring binge in 1998, vowing to increase by 30% its still-secret number of operations personnel. The agency had planned to boost its operatives over a seven-year period.

Now, its Web site is being flooded with e-résumés. In addition to operatives who know foreign languages, the agency is looking for people with degrees in computers, science, engineering, and related specialties. Well-wishers have also sent the CIA "messages of solidarity and offers of help, many from Americans living abroad," says a spokeswoman. Judging by recent events, the CIA can use all the help it can get. *Paul Magnusson*

FEAR FACTOR

A RUN ON DOOMSDAY GEAR

MORE ATTACKS COULD BE ON the way, this time biological or chemical (page 58). And that fear has Americans buying out stocks of gas masks and protective clothing from military surplus stores nationwide, much as they did during the Gulf War. Gas masks are selling for \$14 to \$169.99, depending on their technological sophistication—and that's if you can get one. In New Orleans, Bill Poynot, who owns two military surplus stores, sold out his 60-plus masks in 48 hours to "businesses in high-rises downtown to make employees more comfortable, moms who are worried, and regular folks." The 120 more masks he was expecting Sept. 18 all sold before they arrived.



A MASK won't always work

Mystic (Conn.) Army Navy stores are searching for new suppliers of Israeli-made gas masks after they sold out, too. Customers are also buying British military-issue biological/chemical nuclear protective suits, at \$25, says the stores' co-owner Bert Dahl. The suits are "charcoal-impregnated and absorb chemical agents," explains Dahl.

Experts say gas masks have no guarantee of working, however. "You'd have to do air monitoring on the spot to determine what kind of cartridge or filter and the type of respirator that is necessary," says Joan Baranek, sales director for Air-gas Safety in Bristol, Pa. Says Brent Weiss, a Chicago military surplus store owner: "When I told one customer there were no guarantees on the masks, she said it was 'better than nothing.'" *Ann Therese Palmer*

NEWS FLASH Securities & Exchange Commission Chairman Harvey Pitt is using the crisis to launch a regulatory reform agenda. Emergency measures that let companies buy back more of their own stock—designed to ease the resumption of trading on Sept. 17—are likely to become permanent, Pitt tells *BusinessWeek*. "Why shouldn't we apply them across the board and not just in tragedies?" he asks.

That's just the first of Pitt's initiatives. Next up: letting companies that are issuing stock disclose data via the Net, rather than issuing prospectuses, and a push for financial disclosures more often than quarterly. *Mike McNamee*

UNFRIENDLY SKIES

FOR SOME, IT'S THE ONLY WAY TO FLY

PHONES HAVE BEEN RINGING off the hook at the companies that charter private jets. Since the terrorist hijackings, calls to Petersen Aviation have been running nearly three times the usual five a day for its nine-jet fleet. EBizJets "threw out the answering machine" and started staffing switchboards "around the clock," says John Williams, CEO of the Boston-area charter.

Private jets aren't cheap. Petersen leases Gulfstreams at \$5,000 an hour, making a Los Angeles-New York trip cost as much as \$40,000. But the company says clients are worried enough about airline safety and long security lines at airports that they're willing to pay. Since the death of *Frasier* TV show producer David Angell on one of the hijacked planes, Petersen is getting calls from several TV production companies. Cliff Mayhew, whose Air Charter



PRIVATE JETS are soaring

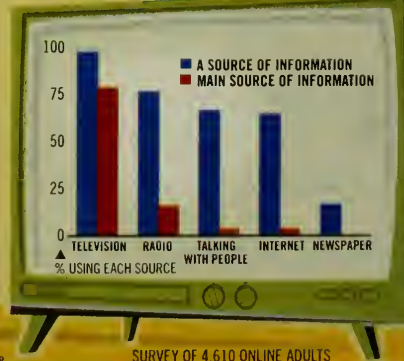
Network books flights other operators, says a paid \$17,000 to fly his family from White Plains, N.Y., to Eagle, Colo., after hijackings.

Some fall-off is certain as the economy cools. But charters hope business keep soaring as major airlines such as Continental, US Airways, and others cut back service. Private jets can fly in and out of many airports. Plus, says Paul T. of Air Partner, a Fort Lauderdale charter broker, "calls are coming from people who want to know even one on the airplane with them." *Ronald Gr*

THE BIG PICTURE

GLUED TO THE TUBE

Americans favored TV coverage to keep them informed about the events of Sept. 11, but many reported using online news as well.



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BusinessWeek began to receive mail about last week's attacks on the U.S. as editors were preparing the Special Report "Terror in America" for its Sept. 12 press deadline.

LIFE AS USUAL IS THE BEST REVENGE

I empathize with those who have not heard from, or who have lost, friends and family in Lower Manhattan, the Pentagon, or aboard those ill-fated planes. I, too, grieve for friends who are missing, and I also hope to receive news of a miracle. But I will not let those feelings deter me from what I need to do, and that is to get on with the business of living my life. For that is what we, as a people, must do.

We cannot let the acts of a cowardly group achieve what is perhaps their main objective—to change the way we live. We must resume our lives, as difficult as that may be. We must go to work, share a smile with our friends, take our kids to Little League, and donate time to those in need. We epitomize what is good about mankind.

Adam B. Dolder
New York

It is ironic that the media are reporting surges in citizens and communities bonding and supporting each other as a result of this tragedy; shouldn't that have been the norm? Perhaps we were too busy working more hours than any other industrial country or tracking our financial portfolios to take notice of our families and fellow citizens!

Mark C. Malham
Port St. Lucie, Fla.

All these fears of consumer confidence falling compare this week's domestic terrorist acts with previous events such as Desert Storm and Pearl Harbor (largely military target) which posed very different threat to the average American. A bit of the wartime "E. American" patriotism may pop out but also a bit of the life-is-so-precious-and-short feeling individuals feel after brush with disaster. If life can be so short and random, won't many people go ahead and buy their kid that toy, without waiting for the December holidays? Do you save the maximum on your retirement account even getting out of debt seem as important to the average American post 9/11/01?

Susan L.
San Diego

GETTING OUT AHEAD OF THE SMOKE

I would like to correct your statement in "The view from ground zero" ("Terror in America," Sept. 24) that "other Lehman Brothers Inc. employees had to evacuate 'engulfed smoke.'" The fire marshals on each floor of the Lehman World Headquarters at the World Financial Center made nearly instant decisions to evacuate the American Express Tower after the aircraft struck the north tower. The evacuation was orderly, efficient, smoke-free. My department was safely outside the building even before the United flight hit the south tower.

Those of us who walked safely away from "ground zero" are acutely aware of the pain of those who were not so fortunate in lower Manhattan, in Washington, and in Pennsylvania, and



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“More knowledgeable”
doesn’t mean
“more marketable.”

Er...wait, yes it does.



I N T R O D U C I N G

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Readers Report

CORRECTIONS & CLARIFICATIONS

In "Media giants are glued to Latino TV" (Media, Sept. 24), the revenues in the past 18 months for the Hispanic Television Network were stated incorrectly. They were \$1.8 million.

thankful for all those whose prompt action saved lives.

Joseph F. Campbell Jr.
Ridgewood, N.J.

THE NEED TO ADDRESS HUMAN SUFFERING IN THE MIDEAST

"What must be done" (Editorials, Sept. 24) chastises "moderate Arab governments" for "allowing extremists to inflame anti-Israel and anti-American passions." Could it be that the Israelis and Americans, in supporting Israeli policy, ignore the losses and longtime suffering of the Palestinians? And in Iraq, at what price and suffering to Iraq's civilians does our policy toward Saddam Hussein cost? Could not Arabs in general feel that we are insensitive to the plight of all these Muslim peoples?

If we want the cooperation of moderate Arab nations and the full support of our allies in dealing with international terrorism we need to consider the Arab peoples' needs for safety, adequate food, health care, and dignity in their countries and homes. Then, maybe, the fanatic terrorist attacks won't draw any sympathy from anyone.

Alison Hopper
Williamsport, Pa.

PEARL HARBOR AND TERRORISM SHOULD NOT BE EQUATED

I sincerely express my condolences to the victims, their families, and people in the States. I am Japanese and I feel as if you said the attack on Pearl Harbor and the terrorism were equivalent. I believe the circumstances of the two events are totally different. I would like to ask you to refrain from using the event in 1941 to describe the terrorism. Please understand how the Japanese feel about your article.

Hidekazu Mishima
Santa Clara, Calif.

THE STAR WARS FOLLY IS NOW REVEALED

Tuesday's devastating terrorist events may have finally proved that the proposed national strategic defense initiative is largely irrelevant to meeting

America's security needs. While we focus on "Star Wars" to protect us, a low-budget perspective was able to envision jets and lax airport security as a one-way ticket to carnage. No high-tech gadgetry has ever matched the prowess of human imagination, however dark its motives. Isn't it time we looked closer to earth for solutions to terrorism?

Douglas Reed
Morrisville, N.C.

A SKYLINE ALTERED FOREVER

I participated in a memorial service today: My company lost two employees in the hijacking and crash of American Airlines Flight 11. After the service, I returned to my desk to catch up on some back reading. I turned to a story several weeks old ("Up, up, and away," *BusinessWeek Lifestyle*, Sept. 3)—and gasped when I saw the beautiful photograph of the World Trade Center taken from an airplane. How long will it be before any of us can look at panoramic views of Manhattan without feeling heartsick?

Marjie O'Connor
Des Plaines, Ill.

DID THE FAA HIT THE PANIC BUTTON TOO SOON?

The terrorists did not and cannot cripple this nation. But the Federal Aviation Administration paralyzed it when it ordered the grounding of all flights throughout this country ("Keeping the barbarians away from the gate," Sept. 24). To achieve their true ends, terrorists rely on fear. They count on us to react in ways that compromise or cripple our own nation's functioning, repeal the civil liberties so highly paid for by our predecessors, and degrade the standard of living that they so despise.

Scott Huntsman
Dublin, Calif.

BAILING OUT THE AIRLINES

The proposed federal bailout of the airline industry should be conditioned on carriers' reducing their presence at any one airport to less than 50% ("How much heavier can the baggage get?" Special Report, Sept. 24). This means big carriers would have to sell off gates, facilities, and other assets to rivals so that no one company controlled the majority of an airport's traffic.

Last week's attack was as much on our system of capitalism as it was on our government, people, and property.

Any bailout of private business, which moves us further away from capitalism, must have a redeeming feature that ultimately makes markets work better.

Kenneth H. Thor
Philadelph.

'EXPERTS' DON'T HAVE ALL THE ANSWERS

Government needs to listen to thinking consumer who can help sensible answers, rather than so-called experts who think like tank command. The current increased security precautions won't decrease a terrorist threat but will take away the freedoms we joy and will destroy the [airline] industry. Instead of parking a car bomb at airport, terrorists could choose a parking garage in some other vulnerable spot.

John R. Heckenly
Culver City, O.

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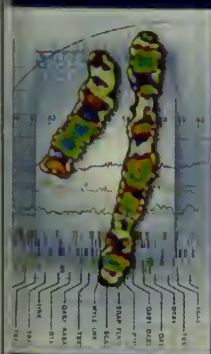
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CRESCENT & STAR

Turkey Between Two Worlds

By Stephen Kinzer

Farrar, Straus & Giroux • 252pp • \$25

WHY GREATNESS KEEPS ELUDING TURKEY

Turkey, with 65 million people and a strategic location between Europe and Asia, is an important country that's not well understood in the West. *Crescent & Star*, Stephen Kinzer's study of Turkey's history and politics, goes a good ways toward redressing that. It's a thoughtful study of the wrenching problems that hold Turkey back—and it's an engaging read to boot.

Kinzer, who until recently was *The New York Times* correspondent in Istanbul, is an energetic reporter who immersed himself in Turkey's vibrant society. He mixed with ordinary people in buses and smoke shops, hosted a Turkish-language radio program, and he even braved tanker traffic to make the one-mile swim across the Bosphorus. Kinzer also logged plenty of evenings in the Turkish bistros called *meyhanes* eating *meze*, or small plates of appetizers, and consuming *raki*, the Turkish national beverage.

That anise-based alcoholic drink resembles its Greek counterpart, ouzo, but don't tell that to the Turks, who believe it is "gloriously unique." *Raki*, which is clear in the bottle but turns cloudy when mixed with water, here becomes a metaphor for Kinzer's experience in Turkey. In the early days of his posting, Turkey seemed "a jewel of a country poised on the brink of greatness." Later, however, he found its future direction to be more murky and began wondering whether his temporary home was "condemned to remain an unfulfilled dream."

He depicts Turkey as a country gripped in a long-term struggle between a young, increasingly well-educated population "eager to build a nation that embodies the ideals of democracy and human rights" and a ruling elite that "refuses to embrace this new nation or even admit that it exists." The irony is

the latter, which he describes as a "sclerotic cadre" of "military commanders, prosecutors...lapdog newspaper editors, [and] rigidly conservative politicians," claim they are acting out of loyalty to the principles of the country's modernizing founder, Mustafa Kemal Ataturk.

Ataturk was a "one man revolution" who ordered the traditional Arabic script to be replaced with Latin characters; banned traditional Muslim garb, the veil and the fez; and tried to stamp out the influence of religion. Yet, more than 60 years after his death in 1938, his legacy has become a strait-jacket. What remains of Kemalism is not so much the founder's enlightened secularism but his autocratic approach. He believed, Kinzer writes, that "the state, not popular will, was the instrument by which social and political change would be achieved."

Ataturk's military successors also think that big decisions are too important to be left to the people or the politicians. What's more, they will go to great lengths to suppress anything or anyone that seems threatening to the state. Dissident writers are packed off to prison. And in the 1990s, the Turkish military waged a vicious war against leftist Kurdish rebels in a vast area in the mountainous eastern part of the country. According to Kinzer, hundreds of villages were burned, suspected rebel sympathizers were assassinated, and torture was widespread.

This hard-line approach tends to backfire. For instance, the country aspires to join the European Union, but its abysmal human-rights record is a major roadblock. And Turkey's authoritarianism breeds inept and corrupt politicians.

Kinzer provides some telling glimpses

of military-civilian interaction. One month, the military commanders met with the supposed heads of government to give them their orders. The beginning of the meeting is televised, the pictures "perfectly convey the sense of power." The civilians squirm "guilty schoolboys." The military commanders glower "at their charges...prepare to deliver their decrees. ways...it is understood that their must be done."

Kinzer is also good on military culture. The officers-to-be, who enter military schools at the age of 14, become a caste unto themselves "priesthood" with Ataturk as their "ular God." They inhabit a world often marrying the daughters of senior officers. They don't see the "vibrant self-confident and boldly ambitious Turkey that many civilians see. Rather they see a nation surrounded by enemies and populated by simpletons."

Although the military still enjoys public respect, the gap between the officers and the people is growing. Several events that occurred during Kinzer's tenure in Turkey helped widen the divide. One was an extraordinary car crash at the time of Susurluk in 1996. When rescuers arrived, they found a top police commander, leader of a reactionary Kurdish feudal clan, and a notorious gangster, all dead in the

Mercedes. Susurluk pulled the lid on a seamy world of political killings, drug smuggling. "For generations I had clung to a childlike belief that never confusing things seemed, the probably knew best," Kinzer writes. Susurluk "began to destroy that faith. So did the 1999 earthquake that killed tens of thousands while the military the government proved incapable of organizing effective rescue operation."

Will the officers back off, allowing democratic Turkish society to bloom? Kinzer in the end is optimistic that generational change will prompt the leadership to "recognize how fully their people deserve democracy." But it seems unlikely that those in power will loosen their grip.

BY STANLEY
London Bureau Chief
also covers the Middle East



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BY STEPHEN H. WILDSTROM

tech@you@businessweek.com

TIME TO SWAP YOUR PALM FOR A POCKETPC?



For calendar and addresses, a Palm is fine. But opt for the PocketPC if you need zippy networking

I have depended on a Palm, or one of its progeny from Handspring, Sony, or others, since the devices came on the market in 1996. But for the first time, I'm thinking of swapping my Palm for a handheld running Microsoft's new PocketPC 2002 software.

I haven't made up my mind yet, because the Palm I use, a sleek Visor Edge from Handspring, does a splendid job of managing my calendar and address book. It's simple, comfortable, and reliable. After several years of trying, the PocketPC has finally made it to a point where it's about as good, although desktop synchronization is still a bit touchy.

My Edge goes for three weeks on a charge, while PocketPCs tend to last only a couple of days. And even a color Palm m505 costs \$150 less than Hewlett-Packard's new Jornada 568 PocketPC.

So why consider change? Simple. The Palm remains essentially what it has always been, a "connected organizer." It's great at exchanging data with a Windows PC or a Macintosh, but its other networking capabilities are primitive. For example, to use sophisticated wireless Ethernet cards, Palms have to treat them as dial-up modems because modems are the only communications devices they understand.

The PocketPCs are very different animals, designed to use corporate networks. In an upcoming column, I'll examine the capabilities of new PocketPC models from HP, Compaq Computer, Toshiba, and others. With the proper accessories, they can connect over phone lines or hook up to local area networks through Ethernet cables or wireless links. For example, I had no trouble using an HP Jornada with a Socket Communications Compact Flash Ethernet card to read and reply to messages in *BusinessWeek's* mail system from my home network.

The built-in software support is as important as the hardware abilities. The PocketPC 2002 software lets you set up multiple networking

profiles to use in the office, at home, and on the road. A virtual private network (VPN) program lets you use a phone line or a high-speed Internet connection at home or in a hotel to reach corporate Web setups or mail servers behind a firewall. The integrated software works with Microsoft-based VPNs, but an add-on program from Certicom (also available for Palm) gives access to VPNs from Cisco Systems, Novell Networks, Lucent Technologies, and others.

There's even a program that allows a PocketPC to log into a Windows NT, 2000, or XP computer running Windows Terminal Server. In theory, you can run any Windows program on a remote computer from a PocketPC, but you'll be able to see only perhaps one-tenth of the screen at a time. This seemingly impractical arrangement can become a powerful corporate tool when running an application specifically designed for the PocketPC's small display.

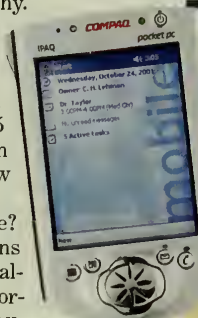
The best software feature is the most common: e-mail program that I have seen on a handheld. You can get access to both your inbox and outbox folders on a corporate mail server, and you

can view and edit common attachment types such as Word and Excel. With a \$100 Targus Stowaway folding keyboard, I think you could get away without a laptop, at least on short trips.

All this power and flexibility comes at a price. PocketPC networking is quite easy to use, but it can be very difficult to set up. And although Microsoft says there will be a setup wizard to simplify the task, it was not available in the beta version for me to test. Even without the wizard, setting up a PocketPC for corporate use may require help from a corporate tech support.

Both Palm and Handspring will come out with new wireless models around the end of the year, but there's no way any Palm can compete with the PocketPC's networking prowess at least until new desktop operating systems hit the market. That's at least a year off.

For now, Palm and PocketPC handhelds seem to be less direct competitors than products in the past, despite a considerable overlap in function, and are actually designed for different markets. If your primary requirement is a simple and reliable way to carry contact and calendar information without complicated communications requirements, you won't be wrong with a Palm. If, however, you need a handheld with sophisticated networking at the office, the PocketPC may well be your best choice.



PocketPCs

WHAT'S TO LIKE :

- ◀ Networking capability
- ◀ Security
- ◀ Display
- ◀ Processing power

BOTTOM LINE: Best handheld for business use

SHOWN: Compaq's iPAQ Pocket PC 3700 series.

Palm family

WHAT'S TO LIKE :

- ▶ Low cost
- ▶ Simplicity
- ▶ Wide array of applications

BOTTOM LINE: Appealing for personal use

SHOWN: Palm pilot m505



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BY ROBERT J. BARRO

WHY THE U.S. ECONOMY WILL RISE AGAIN



SAD TRUTH:
The war on terrorism will free the government to pursue deficit spending, as it should—and prevent a recession

Robert J. Barro is a professor of economics at Harvard University and a senior fellow of the Hoover Institution (rjbweek@harvard.edu).

My objective here is to say some positive things about the fallout from the recent attacks on the World Trade Center and the Pentagon without in any way minimizing the costs in life and property. One silver lining from the attacks is that they probably signal the end of the near-recession we have been experiencing. Some early reactions from commentators and foreign financial markets suggest the opposite: that the U.S. would plunge into a full-fledged recession, which would drag down the world economy. But I think these views are wrong. In fact, the oft-mentioned parallel with Pearl Harbor is also apt in the economic realm.

The U.S. entrance into World War II at the end of 1941 was followed by a boom that shook off the remaining economic problems from the Great Depression. Of course, this economic expansion does not mean that World War II was a net benefit, and the same goes for the recent terror in New York, Washington, and Pennsylvania.

One favorable effect of the current emergency is the breaking of the nonsensical constraint on invading the Social Security surplus. The surplus, projected under one definition of Social Security to be roughly \$160 billion for 2001, corresponds to payroll taxes (contributions from workers and employers), plus interest earnings on the Social Security trust fund, minus benefit payments. From this definition, it is obvious that the Social Security surplus is independent of spending and taxing decisions taken by the rest of the government. Payroll taxes depend only on wage incomes and the given payroll tax rates. Interest earned and benefit payouts are also automatic.

Therefore, it is unclear in what sense the remainder of the federal surplus or deficit would invade or reinforce the Social Security surplus, which is the amount that feeds the trust fund. Hence, the policy that would keep the rest of the federal budget surplus above zero so that the total would remain above \$160 billion never made sense. However, the constraint was not a problem until the economic boom turned into a slowdown and, even more, when a new kind of terrorism brought us into war.

ROBBING PETER. Most economists, whether Keynesians or not, agree that government budget deficits should be large during temporary economic difficulties, of which the two most prominent examples are recessions and wars. Recessions are bad times to collect lots of taxes, and wars are times in which spending is sharply above normal. At present, we have both a recession (at least a near one) and a war (against

world terrorism), and we ought to and will have a federal deficit.

One source of the deficit will be a sharp increase in military, or military-related, spending. The federal government will, in addition, finance a significant part of the coming reconstruction in New York. Expenditures for a sharply altered domestic aviation system will also be substantial. These increased outlays, combined with expanded private investment in New York, are likely to prevent the recession.

The extra federal spending will tend to crowd out other candidates for new public spending, such as education, prescription drugs, and an array of social programs. Since I always regard these programs as mistakes, I view the pressure to curtail them as a plus.

CUT NOW? There is a question about what to do on the tax side. The Bush tax-reduction package mostly had the virtue of eliminating federal revenues that the government would otherwise spend on programs of doubtful value. The rate cuts will improve economic efficiency in the long run, but most of these changes won't take effect for years. Therefore, households and businesses would reasonably expect future tax rates to be lower than current ones and, hence, would be motivated to postpone work and production. A similar adverse incentive applied to the income tax cut of 1981 and likely contributed to the 1982 recession. Since this year's tax rebate has only a minor effect on consumer demand, the net effect of the tax-cut package in terms of countering the current recession threat is probably adverse.

Any further tax cuts should be aimed at stimulating work and production, especially during time of national emergency. Thus, there would be a rationale for immediate cuts in the marginal tax rates that affect households and businesses. These reductions could be accomplished by accelerating the planned cuts in individual income tax rates, lowering corporate tax rates, and reducing tax rates on capital gains. However, an effective loss of at least part of the "peace dividend" from the end of the cold war may mean that some kinds of taxes will have to rise.

Another way in which the terrorist attack eliminated harmful constraints is that it freed the government politically to approach international terrorism as the war that it is. In the long run, this freedom will be the most important. But since I am supposed to have narrow expertise in economics, I will leave the subject to others.

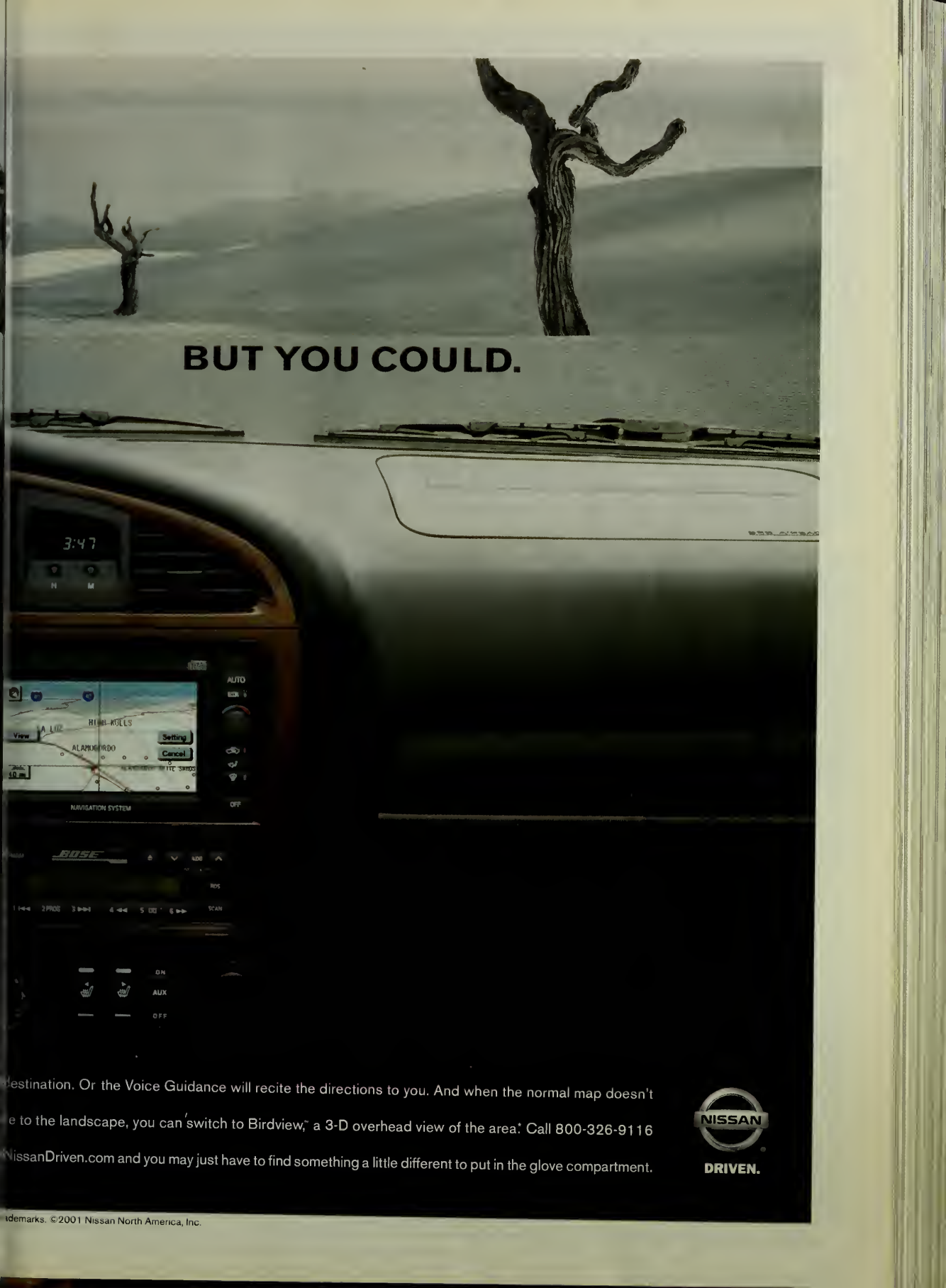
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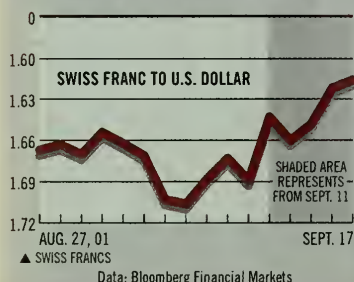
SWITZERLAND IS SITTING PRETTY

Wall Street's loss is its gain

Early this year, when it became clear that among the fallout from the tech-stock bust would be a global downturn, the dollar acquired the patina of a safe-haven currency. Traders believed that the dynamic U.S. seemed likely to recover before any of the other industrialized nations and that the Standard & Poor's 500-stock index still was the best performer of the world's major stock indexes. That's why, despite European policymakers' insistence that Europe would fare better in a downturn than the U.S., the greenback still kept trumping the euro.

So much for the dollar as safe haven.

A SAFER SAFE HAVEN



Sept. 11's attack on America sent rich investors back to their currency bunker: stuffy old Switzerland, land of private banks. Laurie Cameron, a global currency strategist at J.P. Morgan Chase & Co.'s private bank, says that since the disaster, the Swiss franc has risen about 6% against the dollar. On Sept. 17, the dollar was trading at 1.6044 Swiss francs, compared with 1.6886 francs on Sept. 10, the day before the attack (chart). "When there's a crisis, the focus immediately goes to current-account surpluses," says Cameron, who handles foreign exchange transactions for wealthy clients. When calculated as a share of gross domestic product, Switzerland "has a 12% surplus, whereas we have a 4% deficit." Sure, the country has hardly been a hotbed of growth. Since 1998, according to Morgan Stanley, the Swiss economy has grown between 1.5% and 3.5% a year. But inflation has hovered between 0% and 1.6%.

Beyond being a picture-perfect moun-

tain fastness, Switzerland's sophisticated financial infrastructure really does provide a high degree of protection. "Wealthy people understand that it's a safe place.... There's a lot of liquidity. You can take a lot of cash out," Cameron says.

And for all the country's wealth, Switzerland doesn't incite extremist rage the way the U.S., with its conspicuous cultural icons, does. As Paul Podolsky, chief foreign exchange strategist at FleetBoston Financial Corp., points out, "in Switzerland, they may not produce anything, but they don't produce *Baywatch* either."

By Julia Lichtblau in New York

WILL INVESTORS SHUN THE U.S.?

A sobering case study from Spain

Forecasters agree that the Sept. 11 attacks are likely to depress economic growth in coming months because nervous consumers and corporations might stop spending. But a new study published by the National Bureau of Economic Research examines the longer-term consequences of terrorism.

Alberto Abadie of Harvard University's John F. Kennedy School of Government and Javier Gardeazabal of the University of the Basque Country in Bilbao, Spain, looked at the economy of the Basque region—which had to deal with a separatist movement from the mid-1970s to 1998. The terrorist group committed assassinations, extortion, kidnap for ransom, and robbery in a bid to create a separate Basque nation.

The researchers compared the region's gross domestic product with that of other Spanish areas over the 20-plus years of insurrection. They found that Basque per capita GDP was 10 percentage points lower than that of the other regions. The authors concluded the risks associated with terrorism deterred domestic and foreign direct investment, leading to reduced output.

Clearly, there are differences between the Basque experience and recent events. But the U.S. is highly dependent on funds from home and abroad to finance investments on high-tech equipment, commercial real estate, and product innovation. Will that inflow of money continue now that terrorism has struck at home? The sharp sell-off of the dollar against other currencies since Sept. 11 as well as the 685-point plunge in the Dow Jones in-

dustrial average on Sept. 17 are signs that investors are wary of holding American assets. Even U.S. Treasury bonds have lost value as investors unload any securities tied to America. What the Basque study suggests is that if the terrorist situation is not solved quickly, the resulting uncertainty will make it harder for companies to raise the private capital needed to get the economy growing again.

By Laura Cohn in Washington

SMALL SECTORS—BUT BIG DROPS

Why growth is taking such a hit

Although the third quarter had only three weeks left to run after the terrorist attacks, the impact was great that many economists have revised downward their third-quarter gross domestic product estimates, forecasting the first drop in output since 1993. Industries that have seen business drop off sharply include retail, insurance, security brokers, air travel, lodging, and recreation.

While each of these sectors accounts for a small slice of GDP, the falloff has been so severe that it will cause a noticeable drag on overall GDP. For example, air travel and lodging make up 3.2% of nominal GDP, but Maury N. Harris, chief economist at UBS Warburg, calculates that a 10% drop in these sectors could subtract 0.8 percentage points from the growth rate of real GDP, which is the price-adjusted measurement of growth. That's significant enough to turn most third-quarter forecasts negative.

In fact, Harris has revised his third-quarter GDP forecast to a drop of 0.7% from a gain of 0.5%.

And the drag could be even worse. Domestic carriers are already forcing cuts in flights and staff of 20% hotel stays fall by a similar amount that would cut a large 1.6% from GDP. And with Americans still nervous about traveling, there is little chance of losses being made up anytime soon.

By James Mehring in New York

WHERE BUSINESS WILL SLOW SHARPLY

	SHARE OF NOMINAL GDP
RETAIL TRADE	9.3%
INSURANCE	1.4%
SECURITY AND COMMODITY BROKERS	1.4%
AIR TRAVEL	1.4%
LODGING	0.9%
RECREATION AND ENTERTAINMENT	0.9%

*1999 Data Data: Commerce Dept.

JAMES C. COOPER & KATHLEEN MADIGAN

AFTER A BRUISING, THE CASE FOR OPTIMISM

Rate cuts, a liquidity boost, and breaks for business will speed up recovery

U.S. ECONOMY

How bad will the economic damage be? While the outlook still clouded by lingering uncertainty in the wake of attacks of Sept. 11, two views are forming about the economy's future.

One is that a vicious cycle could cause real gross domestic product to shrink for perhaps as long as a year. Already, consumers stopped buying right after the attacks, and companies are warning about declines in business activity and profits. The sharp sell-off of the stock market from Sept. 17 to 19 suggests that many investors may be holding to this "worst-case" scenario.

CRUCIAL REPORTS IN THE WEEKS AHEAD

The effects of the Sept. 11 tragedy will show up first in these economic reports:

BOOK RETAIL SALES SURVEY	(TUESDAYS, 8:40 AM)
TRADING APPLICATIONS	(WEDNESDAYS, 7:00 AM)
UNEMPLOYMENT CLAIMS	(THURSDAYS, 8:30 AM)
SUMMER CONFIDENCE	(SEPT. 25, 10:00 AM)
SUMMER SENTIMENT	(SEPT. 28, 10:00 AM)
CHANGING MANAGERS' INDEX	(OCT. 1, 10:00 AM)
HOUSE SALES	(OCT. 2-4)
EMPLOYMENT REPORT	(OCT. 5, 8:30 AM)

Data: BusinessWeek

restore confidence. As a result, some economists expect U.S. real GDP to drop only in the third quarter. Given the unprecedented tragedy and destruction of Sept. 11, the economy remains in uncharted waters. The guides to the attacks' immediate effects will be the key indicators, along with some key monthly data linking the mood of consumers (table).

EARLY, THE MOOD OF INVESTORS is pitch black. After being closed for four days, the stock markets opened to a fever of selling. The Dow Jones industrial average plunged 685 points on Sept. 17, the first day of resumed trading, another 17 points on Sept. 18, and then opened 144 points on Sept. 19.

Undoubtedly, investors are nervous about war prospects or more terrorist attacks. But, most important, the drop indicates that investors see a weaker economy heightened global uncertainty leading to bigger profit falls than Wall Street had forecast prior to the attacks. Indeed, as the bad news continues to break over investors' heads, Wall Street is beginning to believe that short-term costs to the economy might be higher than first thought.

Another view argues that any downturn will be brief, followed by a solid recovery. This seems the more likely forecast because monetary and fiscal policymakers around the world are using billions of dollars to stabilize the financial system

This worst-case outlook holds that the economy was weakening before the attacks. Now, businesses are warning that the tragedy will cause profit targets to be missed by even larger amounts than anticipated. And many are announcing layoffs.

Under the pessimistic view, this bad news will trigger further drops in stock prices and impel nervous consumers to stop spending. Reduced demand will multiply Corporate America's woes, especially in the capacity-glutted tech sector. The upshot: even slower growth weakens profit expectations and stock prices further, which cycles back to less spending and growth.

A LARGE CONTINGENT of economists, however, have a more sanguine view of the future. They expect any drop in real GDP to last only a quarter or two. After that, the economy will rebound at a healthy clip. Moreover, any recession could be shallow by historical standards, since the economy had made some progress toward a pickup prior to Sept. 11. Excess inventories were shrinking, consumers were still spending, and policy was already accommodative.

The recent actions by policymakers both in the U.S. and around the world increase the likelihood of this so-called weaker-now, stronger-later scenario. These extraordinary times have brought out an extraordinary response. In particular, the Fed is working on two separate fronts: to assure adequate liquidity for the smooth functioning of the payments system and to boost confidence by cutting the interest-rate target (chart).

In the week ended Sept. 12, the Fed supplied an additional \$11.7 billion in loans to banks, the largest weekly effort on record—dwarfing the activity following the 1984 Continental Bank failure. Weekly loans to banks typically average about \$200 million. The figure will surely soar further.

On Sept. 14, the Fed bought some \$80 billion in Treasury, U.S. agency, and mortgage-backed securities. Analysts at Credit Suisse First Boston estimate that the purchases were large enough to finance Wall Street's entire position in these assets. On Sept. 17, the Fed made \$57 billion in additional purchases.

Internationally, the Fed pushed through several mas-

THE FED FLOODS THE FINANCIAL SYSTEM



Data: DRI-WEFA

Business Outlook

sive currency swap agreements with the world's other central banks, including a \$50 billion arrangement with the European Central Bank. These efforts are geared to assuring the liquidity needs of foreign banks that are operating in the U.S. Moreover, the ECB, the Bank of England, the Bank of Japan, and others have all acted together to cut official interest rates.

THESE RATE CUTS, including the Fed's half-point cuts in its target for the overnight federal funds rate and the discount rate, to 3% and 2.5%, respectively, are aimed at instilling confidence in the future. But those cuts only partly validated the flood of new liquidity, since actual borrowing conditions are far more accommodative. The Fed's actions have, in essence, cut the cost of overnight loans to below 1%. On Sept. 19, the effective federal funds rate, determined by market forces, fell to 0.75%, more than two percentage points below the Fed's target.

Economists believe the Fed will take the funds-rate target as low as 2% in coming months. Since the Fed's preferred measure of inflation is also running about 2%, the move would push the real (inflation-adjusted) funds rate down to zero. That's about where it was when the Fed tried to restart the economy after the gulf conflict. And with inflation likely to go lower given shrinking global demand, the Fed has plenty of latitude to take the funds rate below 2% if necessary.

Working in tandem with easier monetary policy will be

fiscal stimulus. Washington is already at work to provide industry subsidies and loan programs, additional tax cuts for both businesses and consumers, and new government spending.

In the next few weeks, some key reports will contain information on how Sept. 11 is affecting the economy right now. Already, the Instinet Research Redbook weekly survey of retail activity showed ominous results. Sales in the first week of September were weak, down a seasonally adjusted 0.7% from all of August. In the week ended Sept. 14, store purchases plummeted 3.2% (chart).

An intra-month shift of that magnitude is enormous for this report, suggesting that the government's measure of sales for the month will be down sharply. However, if the falloff merely reflects people staying home to watch TV, then the reading probably overstates the likely degree of retrenchment in the following weeks.

The coming data will lay out the economic risks that investors, businesses, and consumers will have to live with over the next few quarters. But keep in mind that resiliency and adaptability have been the hallmarks of the U.S. economy. Those traits will be needed more than ever in the year ahead.



AUSTRALIA

RIPPLES FROM THE DISASTER REACH DOWN UNDER

The shift in Australia's outlook shows how the events in the U.S. have changed economic prospects worldwide. Prior to Sept. 11, inflation and the bankruptcy of the nation's second-largest airline were Australia's major problems. Now, the priorities are not so clear.

Australia seemed to have escaped the global slowdown. Real gross domestic product grew 0.9% in the second quarter, up from a 0.4% gain in the first (chart). Interest-rate cuts by the Reserve Bank of Australia (RBA), lower tax rates, and a grant for first-time home buyers boosted demand, especially by consumers. A rebuilding in inventories also lifted growth.

The data for the third quarter have been promising. August payrolls rose by 77,300—the largest gain in more than six years—and the jobless rate dipped to 6.8%. Retail sales looked healthy in

July, and a survey of industrial trends turned positive for the third quarter. Private economists expected Australian real GDP to grow 2.3% to 2.5% in 2001, after a 1.5% advance in 2000.

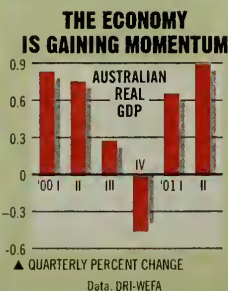
Because of these recent signs of a turnaround, analysts and

policymakers were starting to worry about rising inflation in Australia. The official reading of yearly consumer inflation, at 6%, is skewed by the introduction of a goods and services tax in July,

2000. Economists estimate that, excluding the GST, inflation is running about 3%, placing the rate at the upper end of the RBA target. That's why many thought the RBA was finished easing policy, after it had trimmed short-term rates by 150 basis points this year.

The RBA did not follow the Federal Reserve and European Central Bank in cutting rates on Sept. 17, but it may not be able to hold out if the U.S. and euro zone cut again. Given that a U.S. recession will worsen prospects globally and in Australia, the RBA may cut at least once more, even at the risk of more inflation.

Like many countries, Australia is also feeling the personal loss of the disaster: About 90 Australians are dead or still missing at the site of what was once the World Trade Center.



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RETHINKING TH

So ends an era of calm and security for the U.S. It started more than a decade ago, when the disintegration of the Soviet Union eliminated the country's biggest military threat. Less obvious at the time, the slow implosion of the Japanese economy, which began in 1990, removed the only country that challenged U.S. economic supremacy.

That was the environment into which the New Economy was born. The peace dividend was enormous: Facing no significant external dangers, military or economic, it became safe to shift resources to the private sector. From 1990 to 2000, defense spending fell from 5.2% of gross domestic product to less than 3%, the lowest level in the postwar period. And overall, the public sector's role in the economy dwindled: Total government spending on workers and purchases of goods and services also plunged from 20.4% of GDP in 1990 to 17.6% in 2000, a level not seen since 1948.

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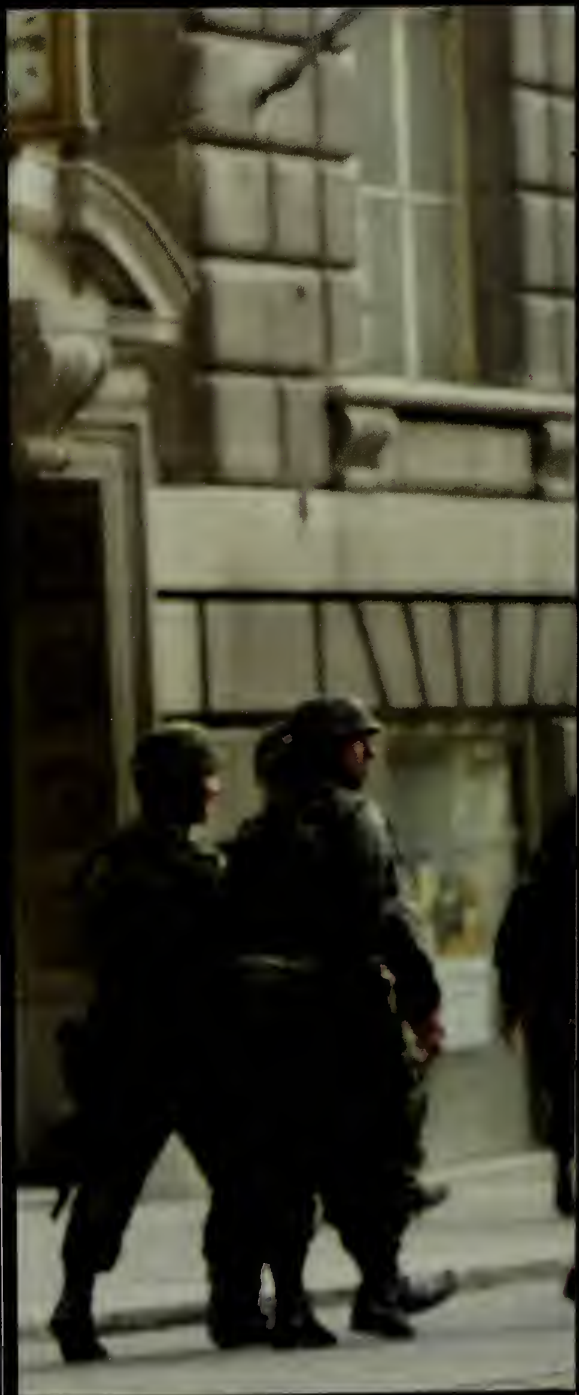
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ECONOMY

After September 11,
the balance between
the private and public
sectors will shift



BETH A. KEISER/AP/WIDE WORLD

Over the same stretch, the private sector thrived. Output soared and the economy expanded in every dimension—globally, financially, and technologically. Foreign trade more than doubled. Venture capital, debt financing, and stock-market values all grew faster than GDP. Vast new telecom and computing infrastructures were created virtually from scratch.

But in the aftermath of the horrendous World Trade Center and Pentagon attacks on Sept. 11, it's clear that the balance between the private and public sectors will shift back in the other direction. Now the country faces the very real threat of more terrorist attacks on American soil and the likely possibility of sustained military action abroad—tasks that the private sector cannot perform. It's striking that in the 1990s the size of the military capital stock—everything from planes to guns to aircraft hangars—actually declined, while the amount of private business capital stock rose 31%.

At the same time, the economic picture seems increasingly foreboding and uncertain, putting pressure on policymakers to intervene. That means a more activist hand in areas of the economy far removed from the military. Even before the terrorist attack, Americans faced a depressed tech sector, a falling stock market, rising layoffs, and a struggling economy. Now it looks like the U.S. could be in for a rougher ride than anyone imagined for the next six to 12 months. Boeing has just announced that it would cut up to 30,000 workers by the end of next year, with American and United each laying off another 20,000. Already the pain is spreading to the tourism, hotel, and restaurant industries. And unless it is immediately successful, military retaliation by the U.S.—along with the prospect of further terrorist strikes ahead—will likely hit shaky consumer confidence hard.

"IMPRESSED." Under these circumstances, it's inevitable that the government will take a larger role in the economy. This year and next, the Pentagon may get as much as \$70 billion over last year's budget, with perhaps another \$17.5 billion going to aid airlines and \$20 billion for recovery efforts in New York City and Virginia. The Federal Reserve is pumping unprecedented amounts of liquidity into the financial markets, temporarily driving short-term interest rates close to 2%. The Bush Administration and Congress are starting to discuss further tax cuts. And with unemployment rising, there will be increasing pressure to strengthen aspects of the social safety net such as unemployment insurance and food stamps. "We have lived through a decade of increasing prosperity and an assumption that it could continue no matter what, and that the government should get out of the way," says Rosabeth Moss Kanter, a professor at the Harvard Business School. Now that's over.

Business executives are expecting the role of the government in the economy to increase. "I do expect the government to act substantively," says William Clay Ford Jr., chairman of Ford Motor Co. "What form that will take I think anybody's guess at this point, but I'm very impressed by what they've already done and how quickly they've acted." Along with airlines, other hard-hit sectors such as insurance and steel are already demanding intervention on their behalf.

Nor does Corporate America seem averse to higher defense spending or tighter security measures. "That's the way it has to be," says Jeff Rich, CEO of Affiliated Computer Services Inc., a Dallas-based information technology-services firm w

HOW THINGS WILL CHANGE



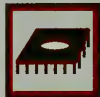
PUBLIC VS. PRIVATE

After a decade of primacy for the private sector, the public sector will take a bigger role in the economy. Government will have a bigger hand in allocating capital, for example, as it bails out troubled industries such as airlines.



DEFENSE SPENDING

Economic resources will shift from private business investment to defense and security-related spending, lowering growth rates.



INNOVATION

R&D money will shift toward technologies that enhance national security and away from innovations that enhance economic productivity.



TRADE FLOWS

Concerns about terrorism will result in costlier airfreight and slower processing at customs, making foreign trade more expensive.



IMMIGRATION

Increased border controls or immigration restrictions could limit the entry of workers, tightening labor markets and slowing growth.



SOCIAL SPENDING

A contracting economy and soaring unemployment will force higher spending on the social safety net.

LESS FREE! The markets have already needed the feds' help

more than \$2 billion in annual sales. "We've probably under-spent on security."

Even conservative Republicans have suspended long-held beliefs about the appropriate size of government. "The words sum up my approach: Whatever it takes," says Representative J.D. Hayworth (R-Ariz.), who was among a group of GOPers that tried—and failed—to pass a constitutional amendment for a balanced budget back in 1997. Too all such talk—along with the now-quiet notion of the Social Security lockbox—has disappeared. "We don't check philosophy at the door, but we need to focus on what hurts. Even Hayworth supports a bailout of the airline industry on the grounds that by shutting down plane travel, the government took action in the interest of nation

TRADE-OFF The risk is that the U.S. will begin to retreat from

fense, therefore compensation is completely rational." As the pendulum starts to swing back to the public sector, there will be economic consequences. At a minimum, the U.S. will likely give up some long-term growth in exchange for more security, both military and economic. Increased spending by the government will mean smaller surpluses, higher long-term interest rates, and less private investment. Already, the prospect of diminished surpluses has sent rates on 10-year government bonds heading up. And with more research and development funds going to projects that enhance security, less will go to those that enhance profits. "The immediate implication of a shift to public spending is a significant reduction in

However, there is a danger that the shift to the public sector could go too far. Historically, times of war and economic distress increase the likelihood that countries back away from market economies. If the U.S. is hit by more big terrorist attacks, or if the downturn is worse than expected, the danger is that Americans will want to retreat from globalization, pull back from risky private investments, and guide an increasing share of technological development to the needs of national security. The result would be self-defeating, leading to a secure, but stagnant country. "I'm worried," says Raghuram Rajan, a University of Chicago financial economist who has studied the history of markets. "We think these markets are invincible and can absorb anything."

STRAINED INSURERS. What's needed is the right balance between the public and private sectors. Consider the slumping economy. The mix of lower rates and higher federal spending could well revive growth next year. Indeed, Daniel E. Laufenberg, chief economist at American Express Financial Advisors, is predicting that the economy will generate 3% growth in 2002.

But that won't necessarily produce a return to the free-market attitudes of the 1990s. Even if growth is positive, the unemployment rate could still keep rising if companies hold down hiring to boost productivity and profits. That's what happened in the early 1990s, when the unemployment rate peaked in June, 1992, more than a full year after the 1990-91 recession ended. A repeat of that experience would put intense pressure on politicians to increase benefits for the unemployed and to boost other social spending.

Moreover, the private financial market may have a tough time managing the combined strain of the economic slump and the terrorist attack, forcing the government to step in and help. So far the financial system has borne up well. The property and casualty insurance industry was overcapitalized by about \$100 billion before the attacks, according to Eric Rajendra,

an Electronic Data Systems vice-president. That should cover even the highest estimates of claims from the attack. Big, healthy insurers may even come out ahead in the long run, if payouts push weaker rivals under and allow them to raise premiums, according to analysts at Standard & Poor's Inc. And while some banks have taken writedowns in recent months to cover delinquent commercial and subprime loans, they're coming from a strong base. "It's pretty impressive to see how well the market seems to have adjusted," says John P. Lipsky, chief economist at Chase Manhattan Bank.

Nevertheless, strains are starting to show. Even though the insurance industry has enough capital overall to handle the losses, some companies may fall short. "If you have some weak companies in the chain, that will cause greater losses for



productivity growth," says Marvin H. Kusters, the American Enterprise Institute director of economic policy studies. To be sure, the U.S. grew so fast in the 1990s that it could afford some additional spending on security. Consider, for example, the effects of giving back roughly half the peace dividend. That would mean shifting about a percentage point of GDP, or \$100 billion annually, into spending on defense and other security-related areas, such as strengthening security at ports and better public health defenses against bioterrorism. Such a reduction in private investment could take about one-tenth of a percentage point off annual productivity growth. To put it another way, if the New Economy boosted productivity growth by 0.5 percentage points, this gives back about one-fifth of the gain.

Globalization and sacrifice some growth for security

the stronger companies," says Robert W. MacDonald, CEO of Allianz Life Insurance Co. of North America. Insurers also happen to be the main holders of the nearly \$9 billion in debt issued by the shaky airlines.

And as unemployment rises, higher rates of consumer defaults and delinquencies could cause havoc in the housing and consumer-finance markets. "[It] doesn't do any good if the interest rate is down to 1% [but] people can't get approved for loans," says Ford. That could force a tightening of credit and lead to yet another call for government intervention.

Another place where the U.S. is searching for a new balance between public and private is the degree of openness between our economy and the rest of the world. During the '90s, free trade and open immigration were two New Economy mantras. The growth of trade during the decade helped stall inflation and boost profits, with about one-quarter of corporate profits coming from outside the U.S. Meanwhile, the flow of people into the country accounted for one-fourth of population growth in the 1990s, helping ease strains in the labor market.

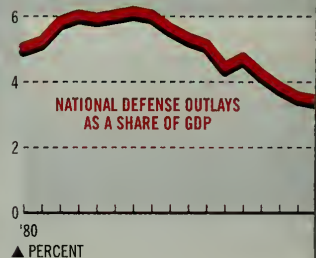
CRIMPED INNOVATION. The terrorist attack hit directly at both aspects of openness. With the terrorists moving freely in the U.S. and even getting pilot training here, there will inevitably be new restrictions on immigration and tighter border controls. Security considerations, such as restrictions on air cargo and more intensive custom inspections, will likely make the cost of shipping goods overseas rise. But that won't do terrible damage to the economy, says Rajan, "as long as we keep our borders open."



DEFENSE IN THE '90s

From 1990 to 2000, defense spending fell to less than 3% of GDP, its lowest level since World War II

THE MILITARY TOOK DECLINING SHARE OF OUTLAYS



Another big worry is that more government activism will reduce innovation. Over the last 30 years, the U.S. developed an unequaled system for funding creative young companies through private financial markets such as venture capital and initial public offerings. During the '90s, the funding for startups soared, providing a key fuel for growth.

This expansion of privately financed innovation was aided and abetted, in part, by a sharp reduction in the resources going to R&D for defense. Since 1988, real spending on that has fallen by roughly 28%, freeing up scarce skills of engineers and scientists for commercial rather than defense jobs.

Now spending for those needs is likely to rise. That's appropriate, but it could dampen the entrepreneurial process that helped create the New Economy. A recent study by the Organization for Economic Cooperation & Development

TREASURY'S O'NEILL ON BAILOUTS AND BUILDING CONFIDENCE

In the aftermath of the Sept. 11 terrorist attacks on New York and Washington, Treasury Secretary Paul H. O'Neill has directed the Bush Administration's plans to shore up the American economy. On Sept. 18, O'Neill met with Washington Bureau Chief Lee Walczak and Senior Writer Rich Miller and discussed the efforts.

Many economists think a worldwide recession is now pretty much inevitable. What's your view?

When you say "worldwide recession," I say, "Where's the data?" Before [the attacks] there were more reasons to be encouraged than discouraged about growth. Now, you have to take a long pause and say, what about after Sept. 11? At the [World Trade Center] site, there is maybe \$10 billion to \$20 billion in physical impact, maybe more. But in the context of the world economy, it's not a stopper. The same is true of the

Pentagon. We can handle the Pentagon and the tip of Manhattan.

A lot is being asked of government right now. What's an appropriate response?

Despite the proximity to the hit, it was really important that the [markets] came back on the first day of trading. That's an important part of rebuilding confidence.... What else can government do? Supplemental appropriations to provide immediate reassurance that the tip of Manhattan and the Pentagon will be rebuilt. At the moment there is thinking about everything that one can contemplate to create momentum in the economy.

What about the psychological damage of the terror strikes?

A lot of economics is a function of confidence and expectations. These are not inconsequential events for our economy and the world economy. We know

there's going to be some damage [shutting down the air transportation system]. The question is, for how long?

What are your thoughts on the situation?

Some airlines were a mess before any of this happened. Some of the things being considered now in individual airlines have anteceded that have nothing to do with the flow assistance to some of the airlines. There are some people who we should federalize the security of air travel, and that's something we have to look at.

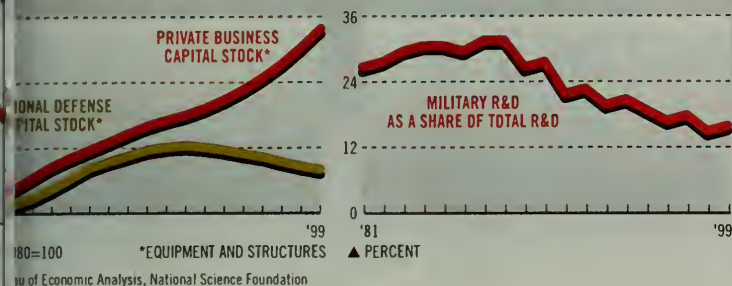
You work for an Administration committed to the free market, but you now find yourself in a situation demanding government intervention. Do you see a clash with your philosophy?

If your principles were right

FALLOUT "In the context of the world economy, [the World Trade Center attacks] are not a stopper."

...GARNERED LESS INVESTMENT...

...AND WAS A LOW RESEARCH PRIORITY



nomists suggests that increases in spending on defense research displaces private R&D. Moreover, increased use of security classifications, says Jay Stowsky, an associate dean at Haas School of Business at the University of California-Berkeley, makes the free flow of information more difficult. Small innovative companies thrive on speed, but the complicated and slow process of defense procurement tends to favor large established companies. "The government is very thochical in their decision-making process," says Scott Mell, senior vice-president of marketing corporate development at software company RSA Security Inc., which gets about 10% of sales from the feds.

re still right. That say that you don't angles, and that is y there won't be npelling cases ie federal govern- l do something as not done in the

worried about a nk check" mentali- pital Hill? A week attacks, there was ver \$60 billion in id.

not keeping score properly. there's \$500 billion [in spend-] out there. And it's going to ng up, and spiraling....

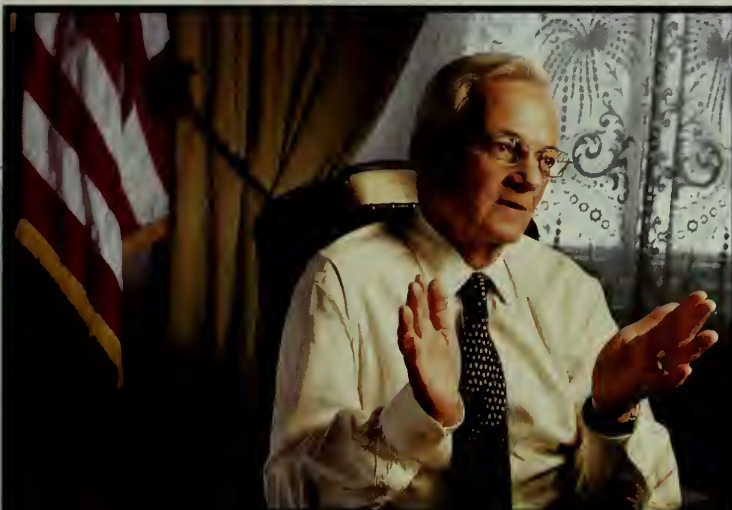
bad thing?

t's not a bad thing for people these aspirations—it's a bad act on them. We need to move ely. The real need of some air- liquidity. We shouldn't provide support for all airlines so they

some execs also believe that rather than deterring globalization, the attacks could accelerate it if countries cooperate against terrorism. "The world is starting to see itself more as one place," says Dennis Kozlowski, CEO of Tyco International, who was in New York at the time of the attacks.

With military action looming, no one knows for sure what the next few months will bring. But no matter what happens, the key is making sure that the balance doesn't swing too far away from the strengths that made prosperity possible.

By Michael J. Mandel, with Peter Coy in New York, William Symonds in Boston and bureau reports.



PAUL O'NEILL. "We shouldn't provide financial support for all airlines so they can now report 20% rates of return"

We need to look at it. [But] you need to do analysis before you take action. We need to do 'Ready, aim, fire,' not 'Fire, aim, ready.'"

The Treasury Dept. already has tried, without much success, to freeze the flow of money to terrorists. What makes you think

you can win the battle now?

We haven't had the impetus that we have now, nor the close coordination around the world. There's a new determination and a new sense that we're going to shut down the financial [system] for these folks.

Does that extend to the Middle East, as well?

This is a case of you're either in or you're out.

le Center's \$20 billion-plus damage] is not a stopper"

THE BUDGET

SUDDENLY, WASHINGTON'S WALLET IS OPEN

Spending restraints go out the window

Forget the lockbox. It's being replaced by the blank check. Rarely have federal budget priorities changed as swiftly as they have since terrorists crashed into the World Trade Center and the Pentagon. Instead of squabbling over budgetary minutiae, Washington has been focused on aiding victims and their families, cleaning up the rubble, and protecting against further terrorist attacks.

Now, as the catastrophes of Sept. 11 threaten to cripple the airline industry, dash consumer confidence, and further roil the stock market, political restraints on spending are all but disappearing. In the first week after the attacks, Congress allocated \$40 billion in an emergency spending bill—borrowing funds from the Social Security trust fund surplus and effectively cracking the so-called lockbox. And the tapping of the trust fund won't stop there.

"SPIRALING." The airlines, shedding employees and travel schedules, showed up at the White House on Sept. 18 with a plea for \$24 billion in bailouts, up from some \$15 billion only the week before. They won't get everything they want, but as of Sept. 19, Congress was weighing a \$17.5 billion package of loan guarantees and cash. "Since government took the action to shut down air service, government has to be part of making industry whole," says Representative Jim Oberstar (D-Minn.), ranking minority member of the House Transportation Committee. Besides the airlines, other damaged industries—including shippers, hotels, and insurers—could line up for bailouts. "[Requests are] going to keep...spiraling," says Treasury Secretary Paul H. O'Neill (page 32).

Many policymakers—including Fed-

eral Reserve Chairman Alan Greenspan—are urging restraint. "We have basically opened the door for anything. This is a real danger," warns Representative Robert T. Matsui (D-Calif.). On Sept. 18, for example, Democrats backed off from their opposition to Bush's Star Wars research, slated to cost \$8.3 billion in the coming fiscal year. So any serious Democratic challenge to the \$100 billion missile-defense program will come later rather than sooner—or maybe not at all.

In fact, money is being appropriated faster than the White House can dish it out. The emergency aid package passed so quickly that the White House had



SORTING IT OUT Cheney and Bush met with congressional leaders at the White House

to scramble to come up with a spending blueprint. The main worry: Washington could slip back to an era of fiscal profligacy and, ultimately, harm the economy.

The damage from increased government spending could also wipe out any remaining federal budget surplus, currently projected to be \$173 billion in the fiscal year that starts in October. And with the country headed into recession, the surplus might not even materialize. Slow economic growth trimmed \$46 billion from projected tax collections from April to July this year,

and revenues could get worse. The big recession, in 1981, quadrupled the deficit, to more than \$200 billion, in just two years.

Besides all that, Republicans are dusting off tax-cut proposals such as reduction in the capital-gains rate, credit and faster write-offs for new business investments, and relaxation of the alternative minimum tax for businesses. And Senate Budget Committee Chairman Kent Conrad (D-N.D.) is considering a tax rebate that would go to low-income workers who missed the \$38 billion round of income-tax refunds this summer.

MORE TO COME. Then there are the lingering promises from last year's election campaign. The Administration wants \$190 billion for an eight-year plan to bolster Medicare and pay for prescription drugs for seniors, beginning in 2003. Democrats would nearly double that. The Administration also wants to boost military spending by \$198 billion over 10 years—by \$18.4 billion in fiscal 2003 alone—an increase Democrats will find hard to oppose. Also on the lists of both Congress and the Administration: reauthorization next year of

BUDGET-BUSTERS?

The 2002 surplus—including Social Security—is now projected to be \$173 billion. Post-tragedy spending would reduce that dramatically

IN THE WORKS

\$40 billion in emergency funding
\$17.5 billion for the airlines
\$8.3 billion for Star Wars R

GOOD CHANCE OF PASSING

\$18.4 billion in military spending

TOTAL \$84.2 billion

* Airlines had asked for \$24 billion

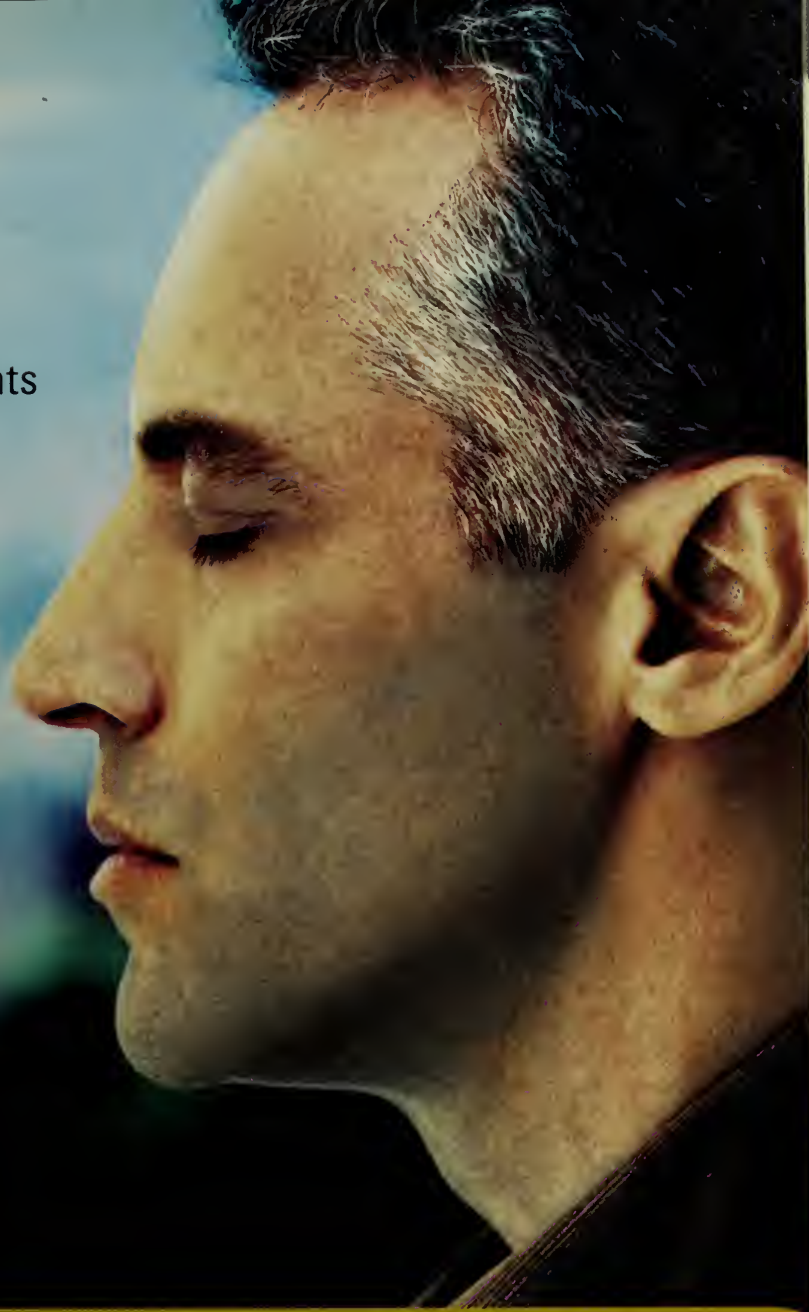
farm bill with a price tag of some \$10 billion over 10 years. The tradition of passing yearly supplemental farm-revenue bills could double that.

The White House insists it is maintaining long-term "budget discipline" even in the face of these new demands. But clearly, given the threat of further terrorist attacks and the likelihood of a recession, Washington is in no mood for talk about austerity and lockbox.

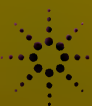
By Paul Magnusson, with Lorraine Woellert and Howard Gleckman in Washington

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AIRLINES

WHAT KIND OF RESCUE?

Cash won't solve air carriers' long-term woes

One week after the crashes of four jetliners on Sept. 11 that led to the deaths of as many as 5,000 people, the airways above America's skies are open for business. But while their planes are again taking off, carriers' financial prospects are grim.

Even after reducing schedules by 20%, most carriers are flying with only about 50% of their seats filled more than a week after the nationwide shutdown sparked by the terrorist attacks in New York and Washington. Airline shares have lost a third of their value on Wall Street, and carriers have lost roughly \$5 billion so far. In a desperate attempt to make ends meet, American Airlines, America West Airlines, Continental Airlines, United Airlines, and US Airways have announced layoffs of roughly 65,000 workers—the first wave of up to 100,000 employees to be let go industrywide. Meanwhile, Boeing Co. has announced an additional 30,000 cuts.

As the fortunes and finances of the airlines plummet, Washington is being prodded to help save a sector that was foundering well before last Tuesday. "We are talking about the safety and the security and the stability of an industry," says Transportation Secretary Norman

Mineta. "Not of one or two or three or four companies, but an entire industry."

That's why even a Congress afraid of setting a precedent of bailing out troubled industries is rushing to aid the air carriers. Details are fuzzy, but the Bush Administration and congressional leaders have agreed on the rough outline of a two-tiered bailout package. First, lawmakers may provide up to \$5 billion in immediate cash to compensate for losses airlines suffered while grounded under federal orders in the days immediately following the terrorist attacks. They also are weighing \$12.5 billion in loans and loan guarantees. The aid would be given to carriers based on the amounts each lost during the three-day shutdown, minus savings on fuel and operating costs.

Following a White House meeting on Sept. 19, House Speaker J. Dennis Hastert said the package should alleviate airlines' cash crunch. That's a blow to the airlines, which had initially lobbied



SITTING IDLE America West tr

for a \$24 billion package of cash, loan guarantees, and tax breaks. Also hanging was a plea to protect carriers from legal liability from the crashes.

Policymakers' reluctance to quickly rubber stamp an airline wish list shows how strong resistance is among some in Washington to bail out a highly leveraged industry that was already on the verge of losing up to \$2 billion this year. "I don't want to make them better off than they would have been prior to Sept. 11," says Representative Roy Blunt (Mo.), GOP point man on the bailout. Treasury Secretary Paul O'Neill reportedly notes that US Airways Chairman

AMERICA'S BIGGEST BAILOUTS

A bailout for the beleaguered airline industry wouldn't be the first time Washington has rescued a troubled company, industry—or municipality, for that matter. The precedents:

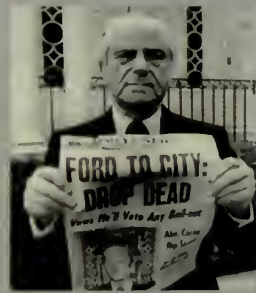
LOCKHEED AIRCRAFT, 1971

Beset by cost overruns, inflation, and lack of demand for a new jetliner, the L-1011, Lockheed Corp. asked Congress for support. The aerospace giant argued that should it fail, its demise would not only imperil the nation's defense and leave 60,000 workers unemployed, it would also

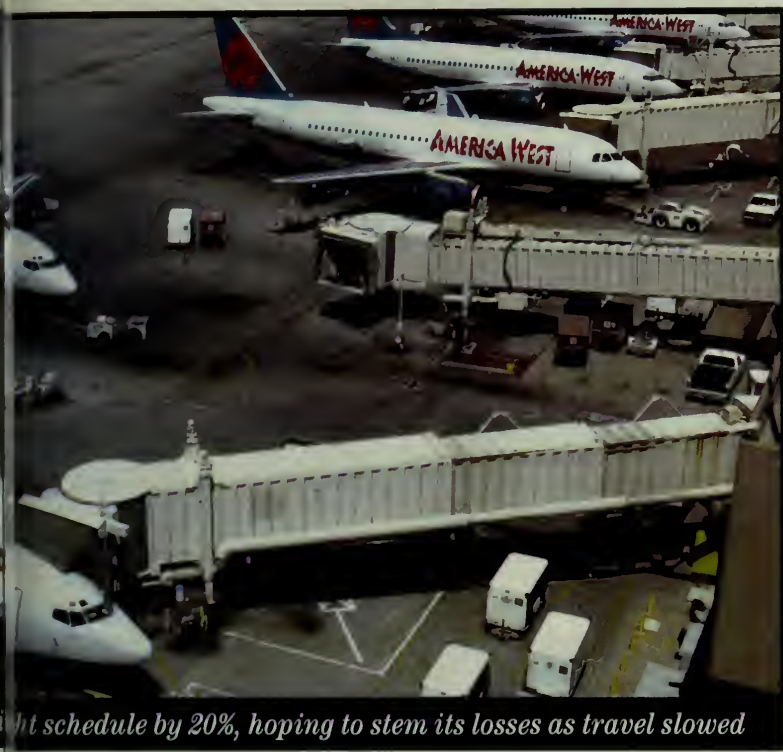
ground commercial airlines that had paid Lockheed for future aircraft. After a contentious debate, lawmakers approved \$250 million in loan guarantees. The turnaround was anything but smooth: Revelations that Lockheed had paid foreign bribes compelled the feds to oust two top execs and closely scrutinize Lockheed's activities.

NEW YORK CITY, 1975

A suburban exodus and a sharp decline in manufacturing jobs led to a broad erosion of New York's tax base in the early



1970s. The newly created Municipal Finance Corp. took over New York's finances and, with the help of \$1.3 billion in federal loan guarantees, implemented austerity measures that enabled



...t schedule by 20%, hoping to stem its losses as travel slowed

When Wolf told him 18 months ago that his airline couldn't survive alone, the airlines were a mess before any of this happened," O'Neill says.

It's only getting worse. U.S. airlines lost \$9 billion in cash on Aug. 31, but revenue expected to plunge 60% in September and 40% through the fourth quarter, the industry would be \$1.1 billion in the hole by November, according to Air Transport Assn. forecasts. Even worse, effective Sept. 24, insurers canceled "war risk" policies, offering U.S. carriers reduced coverage at higher premiums. Argues Delta Air Lines CEO Leo Mullin: "Without immediate financial

support from the government, a number of carriers could be driven to bankruptcy within 60 days, and the future of aviation could be severely threatened."

This notoriously boom-or-bust industry is no stranger to bankruptcy court. Two of the top 10 carriers—Continental and America West—already logged trips there in the 1990s but emerged to fly again. Today, however, lenders view airlines far more pessimistically, thanks to declining revenues, costly aircraft-order plans, escalating labor costs, and sure-to-rise security expenses. "Our ability to obtain additional financing is nonexistent right now," says

America West CEO Douglas Parker.

Indeed, on Sept. 19, Moody's Investors Service downgraded ratings on \$39 billion in unsecured debt of American, United, and Delta to junk levels. So today, not even one of the Big Three carriers may be able to emerge from bankruptcy intact, leaving lawmakers facing the politically ugly prospect of air-service disruptions for communities nationwide.

That has left policymakers little choice but to act. "I don't think the country has any particular interest in letting this situation get as bad as it can before we try to be helpful," says Blunt, who worries that the cascading effect of layoffs and abrogated contracts from a string of airline bankruptcies would surely hurt the U.S. economy.

Even if a bailout helps in the short term, it won't solve airlines' long-term woes. Leverage is heavy, with debt as a percentage of total capital at Northwest, Continental, and US Airways exceeding 85%. And in the past year, big carriers such as United have signed expensive labor contracts with their unions—contracts they will have a hard time paying for in the current air-travel depression. "[The bailout] may very well be not enough for everyone," concedes John Heimlich, an economist at the Air Transport Assn.

Indeed, layoffs, retrenchments, and even bailouts can't give the airlines the one thing that is most critical to a return to financial health: a steady stream of paying customers. Says Southwest Airlines CFO Gary Kelly: "We're better prepared than any other airline, but we can't operate like this indefinitely. We need some revenue coming in the door." But how soon passengers will feel safe enough to fly again is anybody's guess.

By Michael Arndt in Chicago, Lorraine Woellert in Washington, and bureau reports

back on its feet. New York repaid by 1985.

CENTRAL, 1976

After the Penn Central Railroad for bankruptcy, the federal government combined parts of it with failing Northeast railroads to form the Nationalized Consolidated Railroad. The feds then spent roughly \$7

billion to keep Conrail afloat. In 1987, with Conrail's recovery assured, the Reagan Administration sold

the government's 85% stake. It was the largest initial public offering at the time. The government's take: \$1.9 billion.

CHRYSLER, 1979

The Arab oil embargo caught Chrysler Corp. sitting on a mountain of debt as well as a huge inventory of gas guzzlers. President Jimmy Carter agreed in 1979 to provide up to \$1.5 billion in loan guarantees, as long as Chrysler won \$2 billion in concessions from banks, suppliers and unions. New CEO Lee Iacocca cut



costs to the bone, eliminating 53,000 jobs. The company also cornered the booming minivan market. In 1983, the company paid off its loans seven years early, at a profit of \$350 million to the government.

THE S&L INDUSTRY, 1989

An inflationary spiral forced thrifts to pay double-digit rates to depositors, while they were still largely dependent on 3% mortgages written in earlier times. New laws allowing them to engage in speculative real-estate deals also proved disastrous. By the time Congress addressed the crisis in the late 1980s, the tab for shuttering more than 1,000 failing savings and loans had soared to \$124 billion.

(CLOCKWISE FROM TOP) PHOTOGRAPHS BY MATT YORK/AP/WIDE WORLD; TRANS PINS WORLDWIDE. BILL STAHL JR./NEW YORK DAILY NEWS; AP/WIDE WORLD

SOCIAL SPENDING

TUGGING ON A TATTERED SAFETY NET

Stricter rules for government aid will hurt in a slump

If the economy tips into recession and the jobless rate climbs, America's already frayed social safety net will be sorely tested. Throughout the 1990s, Congress and the states took a much tougher approach to programs such as unemployment insurance, welfare, Medicaid, and food stamps than they did in earlier decades. The new philosophy was intended to end dependency on handouts and prod working-age adults into taking jobs. The tough-love approach worked well enough when the economy ran at full employment. But as layoffs accelerate and hiring dries up, millions of Americans could soon be begging for help.

The result could be sharp policy battles over priorities as advocates for workers demand more government aid. Already, the initial skirmishes are beginning on Capitol Hill over the 1996 welfare reform law, which must be reauthorized when it expires next year. "With the economy deteriorating, there's a growing anxiety that more people will need to rely on food stamps, Medicaid, welfare," says Sanford F. Schram, a professor of social work at Bryn Mawr College. "There will be demands made on the system, and people will say that airlines are not the only ones with a legitimate need." **VULNERABLE TEMPS.** The most visible problem is likely to come with unemployment insurance. Already, many part-time and temporary workers go uncovered, because they're often ineligible under the current rules. This has left more employees to fend for themselves, since the ranks of temps have nearly tripled, to 3 million, since the 1991 recession. These workers are more likely to bear the brunt of a job drought because many companies lay them off first.

To make matters worse, many states will be under pressure to tighten up eligibility rules even further. That's because 22 states have allowed their unemployment-insurance reserve funds to run down in recent years, when the good times seemed to make them less urgent. With unemployment rising again, fewer workers are paying into the system just as more former workers need to take money out.

Welfare reform will be another flash



LONG WAIT States will be pressed to further tighten aid eligibility

point. The 1996 law created the Temporary Assistance for Needy Families, which slapped a five-year lifetime limit on an individual's right to collect benefits. The program is administered by the states, each of which started the five-year clock ticking at slightly different times. But most are starting to run out—just as the job market seems poised for a tailspin. Unless Congress eases the rules, mothers who can't find jobs could wind up with no paycheck—and no welfare check, either.

Cutbacks in the food-stamp program could leave many people with nowhere to turn except soup kitchens. The 1996 welfare law took away the right of many legal immigrants to collect government food aid. Although immigration has jumped sharply in recent years, many newcomers have been able to find work and feed their families. But many are unlikely to leave even in a recession, which would cause hunger to increase.

Plenty of U.S. citizens have lost access to food stamps, too. The problem began before welfare reform, the coupons were handed out in the welfare office. But the two programs were delinked under the 1996 law, leading to massive confusion among families who wrongly figured they were ineligible for food stamps unless they were also on welfare. Since 1996, the number of people collecting food stamps has sunk by one-third, to 15 million. It's not just a stronger economy either: Fewer than half of the eligible working families get them, studies show.

FEELING THE PAIN OF REFORM

A recession is certain to add to the rolls of many federal and state-funded social programs, which have been cut back in recent years

FOOD STAMPS Millions of families aren't getting help because welfare reform confused them about eligibility

MEDICAID Welfare reform confusion also has led to fewer eligible families getting aid

UNEMPLOYMENT INSURANCE There are more temporary and part-time workers who are less likely to be covered

WELFARE The 1996 law set a five-year lifetime limit on benefits, so more mothers could be without recourse if they can't find a job

Data: BusinessWeek

The best scenario is a short-lived recession and a jobless rate that doesn't rise much above today's still-low level. Of course, the safety net could still suffer a strain, because a growing glut of low-skilled workers means wages at the bottom are likely to sink no matter what. But the stress would be less severe than it would be if unemployment were to jump to 6% or 7%. Should that come to pass, Congress will have another group in need of assistance.

By Aaron Bernstein in Washington

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WALL STREET

A STREET FULL OF UNCERTAINTY

The fear now: Volatility will get even worse

With the successful reopening of the stock market on Sept. 17, Wall Street took a giant and inspiring step toward recovering from the terrorist attack at its heart. While trying to cope with grief, traders, technicians, executives, and regulators worked all hours for six days to get the system running. They met their Monday morning deadline: With only minor glitches, a record 2.4 billion shares traded on the New York Stock Exchange. The loss on the widely watched Dow Jones industrial average, 7.1%, was in line with those registered in Europe while the U.S. market had been closed. And in the next two days the Dow fell another 1.8%, reaching its lowest level since Dec. 14, 1998.

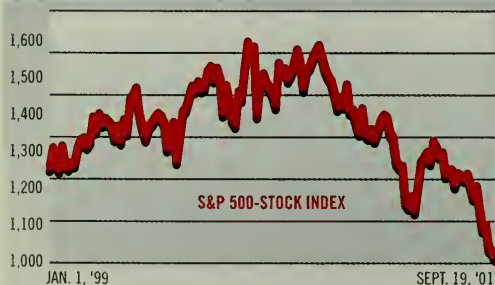
Now, Wall Street faces another ar-

the line to halt any lurch into panic. But, to protect themselves against sudden drops in prices, they'll be less ready to carry as much inventory as they have in the past, removing a buffer against instability. Much of the extra liquidity that helped smooth the market's reopening could evaporate even as Wall Street rebuilds its physical and human infrastructure.

Big firms took every step to make sure trading was as smooth as possible.

Encouraged by the Federal Reserve's promise of liquidity, they called major mutual fund families and assured them that they would have money to buy whatever the funds needed to sell. Liquidity would be no problem, they said. Unlike in the aftermath of the 1998 Long-Term Capital Management debacle, the firms said they would buy stocks themselves, not just act as agents. "Everyone knew there would be selling

STOCKS HAMMERED TO NEW LOWS



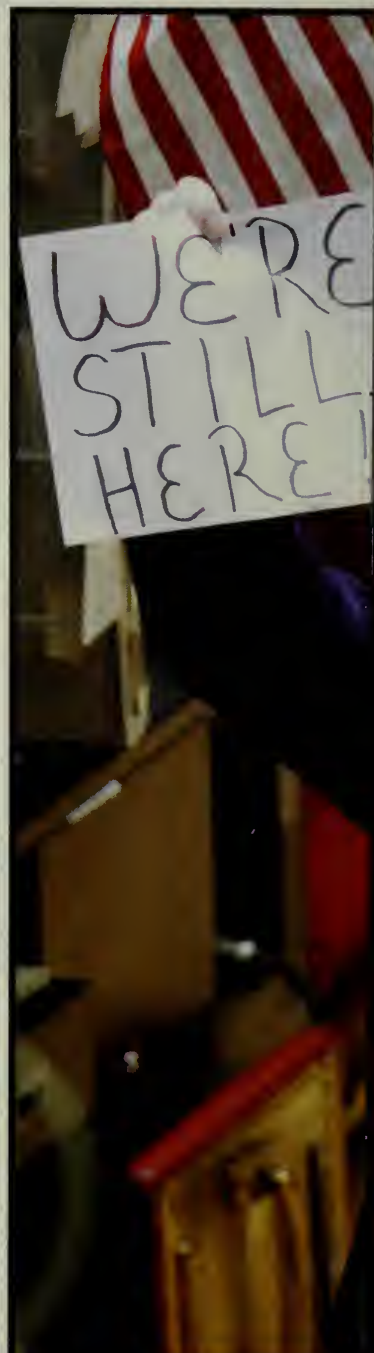
Data: Bloomberg Financial Markets

duous task, one that will last for months: adjusting to a world in which the new war with terrorists has dramatically increased the risk of enormous swings in value. "The patriotic response may have slowed some of what is hitting the market, but it can't stop it," says John L. Manley Jr., strategist at Salomon Smith Barney. "Over the next several months you are going to see a very volatile market."

Investors will want higher returns to compensate for the risks of sudden price shocks. So far, Wall Street firms have said they will put extra capital on

pressure. Everyone's goal was to put as much liquidity as possible against that trend," says New York Stock Exchange Chairman Richard A. Grasso.

For their part, major money managers hesitated to ask the brokers to commit their capital and buy shares without another buyer on hand. "I was surprised at the lack of requests" for the firms to take in stock as dealers, says Mark Kuzminskas, head equity trader at Boston Partners Asset Management. Hank Herrmann, chief investment officer at Waddell & Reed Inc., had wanted to unload retailing shares but backed off



DAY ONE Big firms took every

when their prices fell 10% to 15% before he could complete trades. "We didn't see any wisdom in aggravating situation," says Herrmann.

Decisions to show support for markets seemed to be the order of the new day. Goldman, Sachs & Co. bought \$1 billion of newly issued bonds from Walt Disney Co. It also placed a day



WHO KNOWS? Most analysts are at a loss to gauge the impact on corporate earnings

ers may be less protective of each other. "At the end of the day, if you're a money manager you will do what is best for your clients," says Edward P. Hemmelgarn, chief investment officer at Shaker Investments. The same goes for others, from individual investors to the biggest investment banks. And at some point, to avoid pumping up another stock bubble, the Fed will drain the liquidity it poured into markets.

Even so, on Sept. 17, dealers weren't heroically buying stocks when everyone else was selling. They did little but keep order as the Dow dove nearly 600 points in the opening minutes. "No one felt like it was their obligation to put their finger in the dike," says Laszlo Birinyi, president of research and money management firm Birinyi Associates.

Uncertainty over how the U.S. will retaliate for the Sept. 11 attacks—and worries of more terrorist attacks—will keep volatility high. Besides, most analysts are at a loss to gauge the impact on corporate earnings of the shock to the economy. Before the attack, analysts were estimating earnings on companies in Standard & Poor's 500-stock index would fall 10.2% this year and rise 23.5% in 2002; as of Sept. 19, they expected a 10.5% slide this year and a 20% rise next year, according to First Call/Thomson Financial. But analysts haven't yet updated their numbers. The downward revision

ever felt in terms of predicting what 12 months out will look like."

Even so, many investors are encouraged by the support Wall Street and the economy are getting from Washington. They believe the recovery that was pending before the attack is more certain now because of the Fed's rate cuts and new government spending. However, the big question is what will influence stock prices the most, worry over the earnings collapse or enthusiasm over the potential future rebound. The answers may change from day to day. "You'll see sharp breaks on the downside and sharp rallies," says Merrill Lynch & Co. Chairman David H. Komansky.

BOND BLUES. By some measures, the stock market is in much better shape than it might have been. If the attack had occurred in spring 2000 when the Nasdaq peaked, says Hemmelgarn, the market would have dropped much more dramatically than it has. Instead, the market had already eliminated a lot of its excessive valuations. There was also a lot of money on the sidelines, in cash or in money market funds. Individual investors did not rush to redeem mutual fund shares after the attack. History suggests they'll remain passive and not buy or sell, according to Avi Nachmany at consulting firm Strategic Insight Mutual Fund Research. European investors, significant players in the market, are not rushing to sell U.S. shares, either, says Byron Wien, a Morgan Stanley Dean Witter & Co. strategist. He was meeting with clients in Europe at the time of the attack. "They think things will go back to normal relatively quickly," says Wien.

Although the stock market functioned well after reopening, the \$18 trillion bond market was operating at way below normal volumes. So great were the difficulties of settling and clearing trades when it reopened two days after the attack, that the market had to extend the time for settling bond trades to five days from the usual one in an attempt to clear up the backlog. Corporate bond trading was only 50% of normal. Spreads between dealers' buying and selling prices widened sharply as did their price differences with benchmark U.S. Treasury

sure stock trading went smoothly

ord \$33 billion of commercial paper Sept. 14. And more than 110 companies, including investment bank Morie Stanley Dean Witter & Co and coffee chain Starbucks, announced they were ready to buy back a total of over \$1 billion worth of their own shares. But when Wall Street returns more to business as usual, market play-

tion is likely to become sharper as more factor in a cascade of new earnings warnings and layoff announcements. Eastman Kodak Co. said its third-quarter profit will be one-third less than expected. Viacom said earnings will miss forecasts because of lower advertising revenue and higher costs. Says money manager Herrmann: "I feel about as useless as I've

STAN HONDA/AF

bonds. Indeed, Stephen Kane, a portfolio manager at Metropolitan West Asset Management, said the sell-off in corporate bonds was the worst since the 1998 Russian debt default. Trading in junk bonds virtually dried up.

Worse may be to come for bonds. Already, longer-maturity issues are dropping in price as investors demand higher interest rates to compensate for bigger risks. Indeed, bonds are facing their old bugaboo: a return of federal deficit spending that revives fears of inflation and steps up competition for capital.

In this difficult market, underwriters will be called on to raise capital for in-

surance companies who may have to pay out anywhere from \$30 billion to \$100 billion on property and life claims. That's going to be tough: since Sept. 11 at least four stock offerings for a total of \$1 billion have been shelved.

Merrill's Komansky predicts underwritings will resume by the last week of September, especially in the bond market. His confidence would be unfounded if not for the federal government's steps to save the markets and the economy. If the Fed were not providing capital and Congress were not crafting a bailout to prevent the airline industry from defaulting on more

than \$35 billion of debt, there would be virtually no way the Street could raise capital.

Wall Street never likes having to count on Washington for help. But for now, there's little choice.

By David Henry, with Mara D. Hovanessian and Susan Scherrek, New York and bureau reports

BusinessWeek online

For interviews with David Komansky of Merrill Lynch and Robert Scott of Morgan Stanley go to the Sept. 20 Daily Briefing www.businessweek.com/today.htm

MOBILIZING THE MONEYMEN

On Wednesday, Sept. 19, money in the U.S. was almost free. The fed funds rate, at which commercial banks lend to each other overnight, sank to 0.50%—2½ percentage points below the Federal Reserve's newly reduced target.

An aberration, to be sure. But Fed officials were relieved. It was a sign that their global campaign to keep the financial markets operating smoothly after the Sept. 11 terrorist attacks was bearing fruit. Over the past eight days, they had flooded the U.S. money markets with cash, cut interest rates by a half-point, and goaded central banks around the world into concerted action to avert a world economic crisis.

First priority, of course, was home. Shortly after the terrorists struck, Fed Vice-Chairman Roger W. Ferguson Jr. convened a conference call of representatives from the central bank's 12 regional branches to map out a plan. His boss, Fed Chairman Alan Greenspan, was in the air—incommunicado. The plane bringing him home from a central bankers' meeting in Switzerland had turned back. And its phone lines were jammed. Ferguson and his colleagues issued a simple statement: The Fed's discount window, the lender of last resort for commercial banks, would supply whatever liquidity was needed. **CASH DELUGE.** That would be no small task. With data and phone lines to New York's financial district destroyed, players in the global mar-

kets were worried that money they were counting on—and had pledged to others—wouldn't arrive. Securities firms asked if they could tap the discount window, a step that hadn't been taken since the 1930s. The Fed's response was to flood the banking system. In addition to the billions it lent through the discount

series of transatlantic phone calls, the Fed announced that it had set up a \$50 billion currency swap with the European Central Bank (ECB) to make sure the ECB had enough dollars to meet the cash demands of banks it oversees.

Getting the ECB's president, Wim Duisenberg, to go along with interest-rate cuts was trickier. The ECB had a scheduled monetary policy meeting on Sept. 13, two days after the disaster. But Duisenberg—who had been criticized for his reluctance to cut rates with a slowdown looming—had told a European Parliament committee the day before that the bank was sticking to its usual position: Price stability is its priority. Parliamentarians were dismayed. Sure enough, the ECB held its key rate at 4.25% the next day.

On Sept. 17, Duisenberg reiterated his price-stability mantra in a speech. Markets were perplexed. Later that day the Fed cut rates by a half-point. According to ECB sources, Greenspan called Duisenberg before the announcement to get him to go along with the rate cut. The pressure must have been immense. The ECB cut rates a half-point soon after, throwing market players off-guard. Now, say market sources, Duisenberg's days may be numbered as bankers who lost money on the reversal pressure European policymakers to get him to step down.

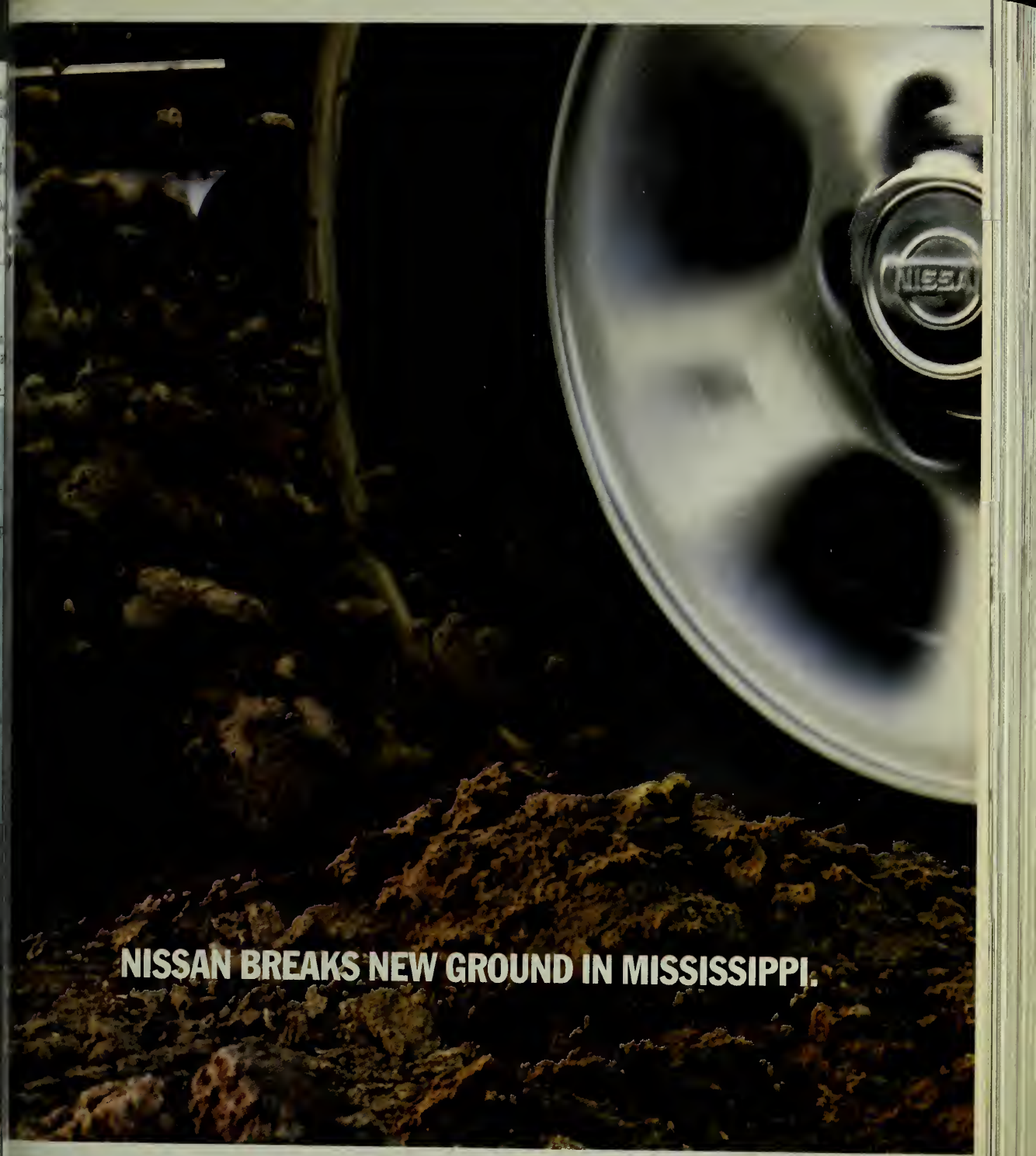
By Rich Miller in Washington and David Fairlamb in Frankfurt



PERSUASIVE Greenspan convinced the European Central Bank to cut rates

window, the Fed pumped tens of billions into the money markets through repos—securities repurchase agreements. The cash deluge peaked on Sept. 14, when the Fed flooded the banking system with \$81.25 billion—many times the \$5 billion or so it normally adds.

Next, the Fed acted to limit the fallout overseas. On Sept. 13, after a



NISSAN BREAKS NEW GROUND IN MISSISSIPPI.

MISSISSIPPI
USA

After over 40 years of building some of the world's most innovative cars and trucks, Nissan is breaking ground once again. This time in Canton, Mississippi, with the construction of a brand-new, leading-edge assembly plant. This plant will have the capacity to build some 250,000 Nissan full-size trucks, full-size sport utility vehicles and the next generation Nissan minivan. All to meet the

increasing demand for Nissan products in North America. Of course, along with creating some of the world's most impressive vehicles, this Nissan plant will also create an impressive number of jobs—potentially 4,000—as well as provide a catalyst for further economic development in Mississippi. In other words, Mississippi's helping Nissan leave everyone else in the dust. For more information on this historic partnership, visit www.mississippiandnissan.com



DIPLOMACY

BUSH'S FRAGILE COALITION

The President must tread carefully to keep global support intact

First came the predictable backing from NATO for an ally reeling from the deadliest terrorist attack in history.

Then support flooded in from unlikely sources: Governments from Beijing to Moscow to Tehran offered not only their condolences but also held out the promise of assistance in the fight against Osama bin Laden.

Should these rarely united nations join forces against the scourge of terrorism, their coalition would dwarf the multinational alliance assembled a decade ago for the Gulf War. In the midst of dozens of sober telephone conversations and Oval Office visits with world leaders, President Bush on Sept. 17 assessed his progress: "The world is rallying to our call to defeat terrorism."

But for how long? Despite Bush's early success, that question remained unanswered. "[The allies] have been supportive," notes Karl-Heinz Kamp of Berlin's Konrad Adenauer Institute. "Whether that holds when the first bombs drop on Afghanistan and Iraq remains to be seen."

Many experts caution that the extraordinary breadth of Bush's mission—to end the threat of terrorist "evil" for future generations—may tax the political will of a fragile global community. The only thing nations seem to agree on is their conviction that bin Laden's fervor for killing innocents is outside the bounds of civilized society.

To build bridges, the Bush Administration is structuring the coalition to permit a sliding scale of contributions from its partners, from lip service to intelligence gathering to providing crucial stag-

ing areas for commando raids. Some, such as Britain and Canada, are likely to send military contingents. Others, perhaps Pakistan and Saudi Arabia, may consider temporarily granting coalition aircraft permission to use their countries as staging grounds for attacks. Pakistan and others, such as China, could exert diplomatic pressure on states that harbor terrorists. Meanwhile, the Administration is pushing certain countries, possibly including Switzerland and Saudi Arabia, to hand over information on the financial dealings of bin Laden and other international outlaws (page 48). Most significant, the U.S. is determined to lift the veil of suspicion

that has kept many nations' intelligence services from sharing information on the global terror network. In a potentially important breakthrough, on Sept. 19, Secretary of State Colin Powell and Russian Foreign Minister Igor Ivanov announced a partnership to share intelligence.

Here's a look at the regional lineup: **■ THE EUROPEANS.** The devastation in Manhattan instantly united a Europe haunted by memories of World War II. In a show of unity, French President Jacques Chirac visited the White House on Sept. 18, and British Prime Minister Tony Blair was to follow two days later. "When we saw the attacks, we identified with the victims spontaneously," says German Foreign Ministry official Karsten D. Voigt. Still, France and

Italy are already growing uneasy about the danger of an overly aggressive U.S. military response.

■ RUSSIA. President Vladimir V. Putin is not an avowed enemy of bin Laden, whose terror network he blames for helping to finance Islamic rebels in Chechnya and bombings in Russian cities. Despite continuing Russian concern about Bush's vow to scrap the Anti-Ballistic Missile Treaty and NATO expansion into the Baltics, Kremlin pragmatists see a payoff from cooperation. They now have a tremendous opportunity to create not just a new inter-

WHERE THEY STAND

SOUTH ASIA By cooperating with the U.S., India and Pakistan are fueling passions of those sympathetic to Osama bin Laden. The backlash could be worst in Pakistan, which has ties to the Taliban, has many fundamentalist schools, and fears a new wave of refugees across its border with Afghanistan.

MODERATE ARAB STATES Governments from Saudi Arabia to Egypt fear radical fundamentalists. But they also fear that a U.S.-backed crackdown could unleash a firestorm of domestic turmoil that could destabilize their regimes.

RUSSIA AND CHINA Both are afraid that religious zealots trained in Afghanistan will strike them. But lacking U.S. concessions on issues such as NATO expansion and Taiwan sovereignty, Moscow and Beijing may balk at joining with the U.S.

EUROPE NATO countries are reluctant to give an open-ended commitment to an American-led military mission without a clearly defined objective or exit strategy. Protracted warfare also could undermine European oil interests in the Middle East.

AT THE P



embrace a Western crusade against Islam. "Because of Pakistan's economically perilous situation and internal instability, it will be extremely difficult for the government of Pakistan to provide the kinds of assistance we might be demanding," says Leon Fuerth, national security adviser to former Vice-President Al Gore.

Given the risks involved, Islamabad is hoping for a major concession in return for helping Washington, including a possible end to American sanctions, up to \$30 billion in economic aid, and mediation of the long-smoldering fight over the region of Kashmir.

■ MODERATE ARAB STATES.

The U.S. can depend on some help from Arab nations such as Saudi Arabia, Egypt, and Jordan, all of which share American concerns about radical fundamentalists. But the Arab states fear that a

lengthy war with thousands of Muslim casualties could destabilize their regimes. "They are faced with two bad options: Join us or stay away from us," says Simon Serfaty of the Center for Strategic & International Studies in Washington.

That's why most Arab leaders plan to keep low profiles in the early stages of any counterstrike. Arab nations are also demanding that the U.S. help spur an Israeli-Palestinian agreement. Israel's Ariel Sharon and Palestinian leader Yasser Arafat agreed to unilateral ceasefires on Sept. 18, actions that give the Administration more leeway with the Arabs. Says Thierry de Montbrial, director of the French Institute for International Relations in Paris: "Americans should use all their weight to bring about a balanced solution."

Bush's challenges in the coming months will be enormous. His coalition is unlikely to survive a sustained military campaign, particularly if targets extend beyond bin Laden to other American enemies, such as Iraq's Saddam Hussein. But the U.S. hopes to keep the broadest alliance together for the longest possible time. Even if Bush doesn't succeed in eradicating evil from the planet, he's determined to find a way to at least start the job.

By Richard S. Dunham, with Lee Walczak, Stan Crock, and Alexandra Starr, in Washington, Paul Starobin in Moscow, Dexter Roberts in Beijing, and bureau reports

Administration plans a sliding scale of contributions from partners

nal climate but a
an international or-
," says Alexander
vlyev, a defense an-
st at the Russian
Academy of Sciences.
But Old School
adliners, such as Se-
city Council chief
dimir Rushailo, fear
ing America a
thold in the tradi-
tional Russian sphere
influence in Central
a. Absent American
cessions allowing a
ger Russian voice in
ro, nationalists are

ely to resist any deep partnership.
CHINA. Like Russia, it has been fight-
Muslim separatists and wants to en-
e that Xinjiang rebels aren't trained
Afghanistan. And some Chinese lead-
see a chance to convince Americans
t Beijing is not a strategic rival. "It's
unique opportunity to overcome the
tion of the past," says David M.
mpton of Johns Hopkins' School of
vanced International Studies. "They
re a chance to make it clear that we
re meaningful security interests."
At the same time, China is edgy
r the prospect of U.S. military ac-
i inside a sovereign state, particu-
ly one on its border. And China's
icy of selling advanced offensive
apons to such countries as Iran and

PRIORITY Can Bush overcome the suspicion that has prevented intelligence- sharing?

Pakistan is still a sore point between Washington and Beijing.

Many foreign policy scholars expect the Chinese to demand a stiff price for any participation. For starters, Beijing would welcome a lessening of U.S. criticism over its intentions toward Taiwan, its occupation of Tibet, and its continuing crack-down on domestic dissent. Says Foreign Ministry Spokesman Zhu Bangzao: "Chi-

na...has reasons to ask the U.S. to give its support and understanding in the fight against terrorism and separatists."

■ **INDIA AND PAKISTAN.** These rival South Asian nuclear powers find their traditional relationships with the U.S. reversed as a result of the Sept. 11 attacks. India, a Soviet ally in the cold war, is eager to please the U.S. and is offering use of its bases. Pakistan, a cold war friend of the U.S., is under intense pressure from Washington to shed its military and economic ties to the Taliban regime in Afghanistan.

But there are limits to any aid Pakistan's rulers can offer Uncle Sam: Powerful Muslim hardliners, including some in the state security forces, could start an insurrection against leaders who

FOREIGN RELATIONS

THE ROOTS OF RESENTMENT

Why so many people hate America

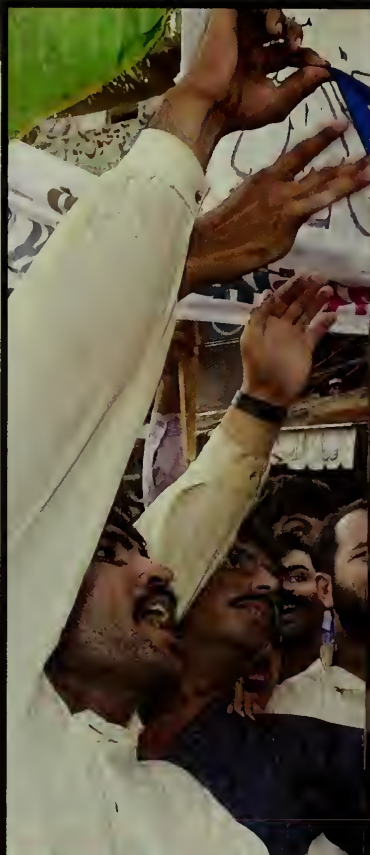
The entire world seemed to pause in solidarity with America suffering in the hours and days following the Sept. 11 terrorist attacks on New York and Washington. With national flags flying at half-mast from Paris to Tokyo and the revulsion and horror expressed by millions around the globe, many Americans felt less alone in a suddenly uncertain world. It even seemed as if the U.S. had no enemies at all—apart from a shadowy band of Islamic radicals in distant lands.

Tap the pulse of the streets in many world capitals, though, and it becomes clear the U.S. fan club is not as big as many American citizens and policymakers want to believe. In France, politicians from across the political spectrum rushed to support the U.S. in a way not seen since World War II. But there also has been a rash of angry calls to the popular Radio France Internationale. "What is so special about the American dead?" asked one caller. "Millions have died in Africa, but they never left messages on answering machines since they were too poor to have cell phones." Half a world away, Chinese Internet sites were jammed with anti-U.S. vitriol before censors clamped down. When he heard of the bombing, Beijing construction site supervisor Li Jiankun, 30, says he felt sympathy for the American people but none for the U.S. government. "They are constantly intervening in other countries' affairs," Li says. "This is an opinion shared by all my

co-workers." And in the streets of Cairo, tour guide Abdel Hady Gaballah voices the sentiments of many: "Everyone knows that America's policies lack justice," he says.

Varied voices, indeed. But they mirror an unpleasant truth: Beneath the surface of public promises of solidarity with the U.S. in this time of crisis lurks a deep and growing resentment of America and its policies. To be sure, anti-Americanism in most places is hardly the virulent variety exhibited by flag-burning mobs. And more often than not, it's mixed with admiration and even a desire to live in America.

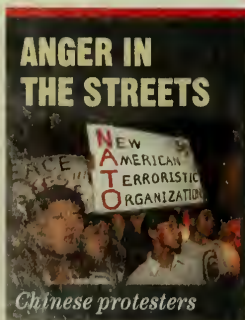
UNDERCURRENTS. But the sentiment is serious enough that it could pose major challenges as President George W. Bush solicits worldwide support for a war on terrorism. Across the 22 nations of the Arab world, strong anti-U.S. undercurrents breed tolerance of terrorist networks like those of Osama bin Laden. And as the U.S. fights back in the coming months, domestic opinion could weaken the support in Europe, Central Asia, and moderate Mideast states for sustained military action, especially if U.S. strikes kill Muslim civilians.



VIRULENT Flag burners in Karachi

The causes of anti-Americanism differ from region to region. And they reflect how much the world has changed since the end of the cold war. American ideology inspired student protesters in Beijing at Tiananmen Square in 1989. And in the early 1990s, the U.S. basked in glory after driving the Iraqi army out of Kuwait. Throughout the collapsed Soviet empire, the American way was viewed as the new model. Following the Oslo accords between Israel and the Palestine Liberation Organization in 1993, Washington was seen as an honest broker in the search for peace.

Canvas the global scene now. Beginning with the turbulent Middle East, war support for eventual U.S. actions will be vital. It is the one region where the



CHINA, May, 1999

U.S. Embassy attacked in Beijing after accidental U.S. bombing of Chinese Embassy in Serbia

GREECE, Nov., 1999

Thousands of anti-U.S. protesters fight Athens police and burn shops

as President Bill Clinton arrives

FRANCE, April, 2000

McDonald's employee dies in bombing of restaurant in Dinan by nationalists opposed to the U.S. chain

YEMEN, Oct., 2000

Bomb kills 17 sailors

on USS Cole after anti-U.S. protests over Israeli attacks on Palestinians

IRAN, Dec., 2000

Marchers burn U.S. flags and chant "Death to America" on anniversary of 1980 takeover of U.S. Embassy

CANADA, April 2001

Thousands march in Quebec City, heads of state for Summit of Americas seek regional trade

NEW YORK, May 2001

U.S. is voted most hated human rights



Pakistan's possible cooperation with the U.S.

mericanism is now metastasizing out of control. At its most extreme, groups such as bin Laden's Al Qaeda network or the underground al Gamma al-Islamiyya, responsible for the murder of 58 tourists in Egypt in 1997, view America as the chief power that is spreading its pernicious, secular culture, the Great Satan that pollutes the world with its pornographic cinema, its alcohol, and its unequal treatment of women. America is also seen as the prop for corrupt, secular Arab regimes, and of course, Israel. To these radicals, it is imperative that Americans be violently driven out of *Dar al-Islam*, the lands of Islam.

While only a tiny minority support terrorism, this stance strikes a chord among vast segments in the Middle

East. The decade-old *intifada* among Palestinians has intensified smoldering resentment in moderate states such as Egypt over massive U.S. support for Israel. And while these nations backed the Persian Gulf War coalition against Saddam Hussein, they're angry at years of U.S.-led sanctions against Iraq. One sign: a Sept. 12 anti-U.S. demonstration in Kuwait itself. "The Arabs sense they have been not only scorned by the U.S., but considered somewhat less than human," says political scientist Dan Tschirgi of American University in Cairo.

The failure of key Muslim nations to benefit from globalization has created

a more fertile ground in which extreme ideas can grow. While the U.S. boomed in the 1990s, Arab economies grew by a mere 0.7% annually. Unchecked population growth has resulted in massive youth unemployment. This has been coupled with a breakdown in social services. Indeed, across huge swaths of Western and Northern Africa and all the way to Pakistan, Islamic institutions—schools, welfare groups, even hospitals—have been stepping in to fill the gaps. "You can see people switching loyalties to an Islamic belief system as secular, liberal models fail for them," says Mark Malloch Brown, head of the United Nations Development Program.

The same trends are at work in the old Soviet republics of Central Asia.

Since 1990, the economies of Kyrgyzstan, Turkmenistan, Uzbekistan, and Tajikistan have shrunk dramatically. But a gush of U.S. aid in the early 1990s has slowed because of frustration over the slow pace of economic reform. "The social consequence is that you see an unhappy population that is moving toward Islamic fundamentalism," says Kathleen Collins, a University of Notre Dame researcher who has spent three years in Central Asia.

SCHEMING. Economic despair isn't the only ingredient for anti-Americanism. Take China. It has prospered over the past decade. But according to popular sentiment stoked by Beijing, the U.S. is scheming to keep China from becoming a world power. Many Chinese resent U.S. support of Taiwan and its criticism of Beijing's human rights abuses. "The Chinese do not support violence against America," says Gao Chaoqun, executive editor of *Strategy & Management*, a Beijing-based policy journal. "They just resent the U.S. hegemony."

Washington also cannot take the current front of European solidarity for granted. In Russia, there is resentment over Bush's plans to renounce missile control treaties and a feeling that the U.S. didn't offer enough aid after showering it with capitalistic advice. Among the left in Western Europe, the march of U.S. free-market policies and the abrogation of the Kyoto global warming treaty have sparked a globalization backlash. Members of France's center-left coalition government also are starting to chime up. "The reality is that American policy could only result in the kind of terrorism we've just seen," says Green Party member Noël Mamère.

For the past decade, a triumphant America has been able to push its agenda without worrying too much about what everyone else thought. That may well have to change if it wants the rest of the world's help for the fight ahead.

By John Rossant in Paris, with Pete Engardio in New York, Dexter Roberts in Beijing, Susan Postlewaite in Cairo, and Paul Starobin in Moscow



SWEDEN, June, 2001
Outraged at Washington's refusal to sign the Kyoto global warming accord, protesters in Gothenburg clash with police during George W. Bush's

◀ **Ronald McDonald:**
Target of French ire

first Presidential trip to Europe

CUBA, July, 2001 Some 1.2 million march in Havana as Fidel Castro leads nation's biggest anti-U.S. rally in four decades

SOUTH AFRICA, Sept. 2001 U.S. boycotts

World Conference Against Racism after it is criticized for past slavery

PAKISTAN, Sept. 2001 Celebrations break out after the World Trade Center and Pentagon bombings

Data. BusinessWeek

TERRORISM

FOLLOWING THE MONEY

Bin Laden relies on accounts too small to track

During Friday sermons in mosques in Saudi Arabia, the imams—preachers—often ask the congregation to donate money for a good Islamic cause. Why not help the Chechens, most of whom are Muslims, fight against Russia, the imams cajole. The faithful hand over their riyals on their way out, and the money is whisked away.

Many of those funds actually reach legitimate causes. But the Saudi government is now stepping up efforts to monitor such giving. That's because knowledgeable banking and intelligence sources say that in recent years a sizable chunk of the collections has been diverted to Islamic extremist groups, including those linked to Saudi-born fundamentalist Osama bin Laden. Wealthy Saudi and Persian Gulf businessmen are another source of financing for bin Laden's Al Qaeda network. Many prosperous families in the region have at least one or two members with a strong fundamentalist streak, intelligence sources say. Besides, Muslims are encouraged to donate 2.5% of their annual increase in wealth to charity.

Pass-the-hat donations, wire transfers from businessmen—this is the stuff of Osama bin Laden's financial operation. Profits from Afghanistan's opium trade may also figure, say diplomats. The terrifying ability of bin Laden to strike where he wants would seem to imply the existence of some vast, sophisticated money machine behind him. Instead, the Saudi militant and his followers use simple, direct techniques that often rely on cash and bank accounts too small to monitor easily. "It is very difficult to see into the household finances of the Middle East," says a well-placed European diplomat. Extremists "get money from drugs, collections, nongovernment organizations. [And] important people afraid of being attacked pay protection money. You can't pin it down to names and addresses."

That's why it will be hard to shut down the terrorists' money pipeline. Of course, the U.S. Treasury Dept. and the FBI will now try their hardest to map

out bin Laden's funding. "Following the money trail will assist immensely in this investigation," says Jimmy Gurulé, Treasury Under Secretary for Enforcement. On Sept. 14, the Bush Administration created a new Foreign Terrorist Asset Tracking Center to coordinate efforts by financial and intelligence agencies in the fight to interdict terrorists' cash flow. The Treasury Dept. has launched a review of all bank reports on suspicious account activity, as well as cash transactions of \$10,000 or more. Banks worldwide are scurrying to investigate whether the suspected hijackers had accounts with them or engaged in suspicious purchases with their credit cards.

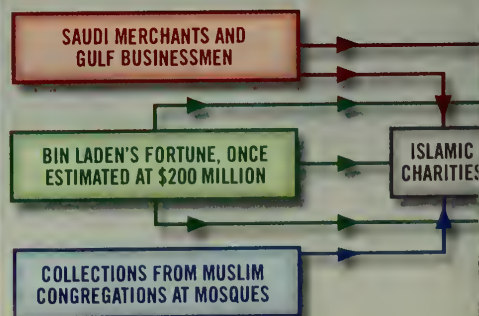
UNDETECTED. For regulators tracking bin Laden's funding, the task is hugely complex. For starters, the money originates from abroad. Take those wealthy merchants, construction magnates, or bankers who donate directly to the Islamic militant groups. Security specialists believe they wire funds to bank accounts in places like London, Hong Kong, or Dubai that are held by Islamic charities, businesses, or individuals who front



LOW-BUDGET: Terror networks

FINANCING THE JIHAD

Analysts figure that terrorist cells receive sums in chunks of less than \$10,000 to avoid detection



محمد بن
الاحمد

for the militant Islamic groups. In 1999, U.S. intelligence agents reported that Dubai Islamic Bank in the United Arab Emirates was a conduit for bin Laden funds. The bank declined to comment. On Sept. 19, Barclays Bank froze a suspicious account, although the bank says the account was long inactive. Thousands of such accounts could exist.

Another reason terrorist funds are hard to follow is that the wire transfers are believed to be small in size. Analysts figure bin Laden's terrorist cells receive sums in chunks of less than \$10,000 to avoid detection by banks and regulators in the U.S. It's easy for a gulf merchant with an offshore bank account to carry out such a transaction. And Saudi Arabia permits unlimited cross-border wire transfers. While transfers are reported to the government, monitoring is mainly for national statistical purposes, not for policing. Some \$18 billion leaves the country this way each year. Terrorist funds are a small portion and could slip out undetected.

When the cash is brought into the U.S., it finances a low-budget operation. Preparations for the World Trade Center and Pentagon attacks involved supporting operatives in the U.S., flight training, and buying air tickets for the hijackers. Yoram Schweitzer, an analyst at the International Policy Institute for Counter-Terrorism in Herzliya, Israel, estimates the cost ran into the hundreds of thousands of dollars—not millions. "When you closely analyze their activities, we're not talking about a great deal of money," he says. At the recent trial of bin Laden followers accused of the 1998 bombing of the U.S. embassies in Kenya and Tanzania, a former bin Laden operative said he was paid only \$500 per month.

All of this seems surprising since the 44-year-old bin Laden has a reputation for being a wealthy man himself. The Saudi native is one of 52 sons of the late Mohammed bin Laden, who was once Saudi Arabia's most prominent contractor and was closely linked to the

Saudi royal family. After Mohammed died in 1966, Osama inherited a fortune estimated at \$200 million. But he's now estranged from both his family and his country, and Saudi sources say he has dissipated much of his wealth. Saudi authorities froze many of his assets in 1991 after he broke with the royal family for bringing U.S. troops into Saudi Arabia to fight Iraq. Bin Laden himself may have used his funds to invest in Sudan and secure its help as a base of operations. Bin Laden's interests there are said to have included a construction business, a tannery, and an agricultural products export business. Saudi sources say those investments have been money losers.

HAMSTRUNG. If bin Laden's personal wealth is running out, can U.S. and other authorities stop the flow of money to terrorist groups? The U.S. needs to push for more effective monitoring, especially in the Persian Gulf region. But cracking down is easier said than done. While Saudi Arabia may seem like a tightly controlled society, its Hanbali system of Islamic jurisprudence puts great emphasis on the sanctity of private property. "What you do with your money is utterly up to you," says Michael Field, London-based author of several books on business in the gulf. "People can walk around with very large sums of cash in bags." Thus, when the French internal security service confronted the Saudis with evidence that the Islamic Salvation Front (FIS), a hard-line Algerian group, was funded from the gulf, the Saudi government said there was little it could do.

It would take unprecedented cooperation from governments and banking centers globally to close down bin Laden's funding completely. Without that effort, his cut-rate terrorist groups can still afford their dirty deeds.

By Stanley Reed in London, with John Rossant in Paris, Mike McNamee in Washington, and Heather Timmons in New York

PERSONAL OR BUSINESS
BANK ACCOUNTS IN
LONDON, HONG KONG,
DUBAI, AND OTHER CITIES

CASH

BIN LADEN ASSOCIATES
IN U.S., GERMANY,
MALAYSIA, SUDAN,
AND OTHER COUNTRIES



UNWITTING? Islamic charity is often misused

COMMENTARY

By Mike France and Heather Green

SECURITY VS. CIVIL LIBERTIES

Journalists, civil libertarians, and other professional alarmists cry "Big Brother" too frequently. But none of the privacy controversies of recent years—indeed, no event in modern history—has brought the prospect of Big Brother closer to reality than the World Trade Center horror. The thought that the same attackers might have access to biological weapons and other advanced technology forces us to reach for an equally powerful and futuristic

with which to strike back. Suddenly, proposals are gaining legitimacy that were all but unmentionable a month ago. Calls are being made for the establishment of databases of information about what citizens look like, where they go, and what they do; for the use of surveillance technology to monitor the nation's e-mail traffic; and for the imposition of a national identification card, to name a few.

Many of these steps may well be necessary. Terrorism is a much greater threat than previously imagined. As a result, familiar arguments against government surveillance are going to have to be reconsidered. Of particular concern is the possibility that there may be still more terrorists living in the U.S., raising children, and doing an excellent impersonation of ordinary citizens. That means law enforcers may have no choice but to treat everybody like a suspect—which would justify much wider government surveillance than most Americans would have accepted just weeks ago.

NO BLANK CHECK. The increased threat doesn't mean, though, that the FBI, the CIA, and other law enforcement agencies should simply be given a blank check. Civil libertarians worry about government surveillance for good reason: Those in power have used sensitive personal information many times in the past to target political enemies and harass innocent citizens. This is fundamentally anti-American—and it isn't ancient history. Congress passed the Privacy Act of 1974 after revelations that the FBI had gathered files on everyone from Rock Hudson to Henry Ford to César Chavez. "It is so important for the debate to get past the point where one side is saying, 'We've

got to give up civil liberties,' and the other side is saying, 'We cannot give up civil liberties,'" says University of Southern California constitutional law expert Erwin Chemerinsky. "It has to be a much more nuanced discussion of what civil liberties are being compromised, under which circumstances, and for what gain."

So while everybody wants more security—especially those of us in New York who witnessed the terror firsthand—we

need some form of public debate about our liberties are permanently curtailed. Right now, because of the urge to act swiftly, there's reason to believe that may not happen. On Sept. 13, Sen. Patrick Leahy (D-Vt.) blasted colleagues for passing an amendment expanding federal electronic-surveillance authority after less than an hour's worth of discussion. "Do we really show respect for American people by slapping something together, something that nobody

floor can explain, and say, 'We are going to change your right to privacy?'" asked Leahy.

Even in the midst of a crisis, his concerns are not unfounded. At a minimum, law enforcement should be required to provide some proof that the new security tools will do some good in the fight against terrorism, especially since many of the technologies under discussion are based on completely unproven, and may not be a cure-all in any event. Then, Congress quickly needs to analyze whether that benefit is worth the resulting damage to civil rights. Additionally, a "sunset" provision should be added to new antiterrorism laws forcing lawmakers to reconsider the law, say, a few years. That will ensure that a measure passed during a time of crisis doesn't burden the country when the crisis passes. Finally, we have to be careful about how we define terrorists. Potentially, there's a thin line separating them from protesters of globalism, G.I. peace members, or militia.

Unfortunately, U.S. history is littered with examples of perceived overreactions to military threats. Abraham Lincoln suspended basic criminal rights for soldiers during the Civil War.

HOLDING BIG BROTHER AT BAY

In the understandable rush to put in place new laws to fight terrorism, rights could be trampled. Here's how to strike a balance:

MAKE SURE TACTICS WILL IMPROVE SECURITY

Interning Japanese civilians during World War II did little to make us safer. Let's not make the same mistake. Law enforcers should offer some proof that new surveillance and legal tools will be effective.

BALANCE THE CIVIL LIBERTIES COST

Once lawmakers are satisfied that a new proposal could work, they quickly need to weigh the cost to people's liberties. Not all the rights at stake—to enter the country, be free from surveillance, and be able to defend oneself fully in a criminal trial—are equally important.

ADD A "SUNSET" PROVISION

We won't always be in a crisis situation. Let's give ourselves a chance to reconsider some of the laws enacted in this panicked moment by forcing lawmakers to reconsider the new rules after, say, three years.

DEFINE TERRORISM CAREFULLY

What exactly is a terrorist? Does a militiaman count? A protester of globalism? It is all too easy to expand the definition of a terrorist to include legitimate and peaceful fringe groups.

Data: BusinessWeek

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r ideas may be problematic. For
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pushed to give law enforcers a
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ble is, these steps wouldn't work.
l guys can easily buy encryption
ogy from companies in Russia.
more, installing a back door for
orcers would make the software



CAUTION

Broadening
wiretap laws
will help the
fight against
terrorism,
but restricting
exports of
encryption
software
won't

*A closed-circuit camera
records sidewalk traffic
near the Bank of London*

vulnerable to hackers. That, in turn,
would make the technology less valuable
to the energy, finance, and e-commerce
industries that depend on it to guard
their networks. "Cryptography protects
an increasingly critical infrastructure,"
says Matt Blaze, a research scientist at
AT&T Labs. "Although the wide availabil-
ity of cryptography can benefit crimi-
nals, it also protects us."

Other aspects of the upcoming priva-
cy debate aren't so black-and-white.
Consider Carnivore, the tool the FBI un-
veiled last year to monitor e-mail and
instant messages. It could be a powerful
weapon against terrorists, but it also
gives the feds unprecedented power to
monitor what citizens say and do on the
Net. Unlike a wiretap, which lets police
overhear conversations on one phone,
Carnivore lets them monitor everyone
who uses the same Internet service
provider that the suspect uses—whether

they're under investigation or not.

Because the new terrorism threat
seems so grave, Carnivore should be al-
lowed to go forward. But new rules are
going to have to be put in place quickly
to ensure that it isn't abused. One good
idea: having an independent legal au-
thority, perhaps a judge, periodically
audit the data cops collect to make sure
that innocent people aren't being illicit-
ly tracked.

Several other tough issues also lie
ahead, including such proposals as a na-
tional I.D. card and biometric profil-
ing—an emerging technology that lets
law enforcers develop a database of peo-
ple's faces, fingerprints, or the unique
patterns of their eyes. These steps may
well be necessary. But let's not rush
into them blindly.

*With Jim Kerstetter in San Mateo,
Calif., and Dan Carney in Washington*



THE METROPOLIS

THE FUTURE OF THE CITY

New York's vulnerability raises serious questions

In the horrible days following the death of 5,500 New Yorkers and the destruction of the World Trade Center, businesses and citizens alike have been quick to reaffirm their commitment to the city. From American Express Co. CEO Kenneth I. Chenault's vow to keep his headquarters in the

city to developer Larry A. Silverstein's promise to rebuild the World Trade Center—which experts estimate could take five to seven years and cost \$10 billion—civic pride was everywhere. But as New Yorkers resume the familiar routines of city living, from boarding the subway to boarding high-rise ele-

vators, big questions remain about how well New York will survive this crisis.

As the terrorists intended, the attacks dealt a body blow to the financial-services industry. Now, as firms scramble for space, there is even some question whether New York will remain the country's financial center. If it does

not, can New York still thrive? Already, many of those displaced companies are seeking temporary quarters in New Jersey, Connecticut, and elsewhere—where city officials scramble to prevent those moves from becoming permanent.

And it's not just the future of one business sector in one city. The disaster raises larger questions about the function and future of all cities. As New York's recovery grinds on, urban scholars, architects, and sociologists expect a new debate on the very viability of cities. Are the benefits of concentrating so many people in a narrow space worth the risks—particularly now when the Internet and other technologies are providing new ways to work? The debate could shape up as the latest challenge to the '90s comeback of the city.

"FIRST MAGNITUDE." It seems unlikely that this attack could lead to another middle-class exodus like that of the 1970s—which left New York crime-ridden, with its cultural landmarks in jeopardy and its government one step from bankruptcy. But all agree that the New York that emerges will be fundamentally different in spirit and structure from the one that people hustled through on their way to work that morning. "This is a tragedy of the first magnitude, and we can't step back," says Kenneth T. Jackson, professor of history at Columbia University and

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director of the New York Historical Society. "But New York has a diversity of experiences that energizes people, and I don't think we're going to lose that."

Even if, over time, New York is bound to recover, in the shorter term the disaster is sure to batter the city. For one thing, Jackson points out, the events challenge the revival that U.S. cities enjoyed in the 1990s. New York and other metropolises thrived as the idea took hold that they were safe again. In the past decade, as crime declined, a century-long trek to the suburbs began to slow. Boosted by immigration, some cities, including New York, even showed surges in population in the 2000

ensus. Now, says psychiatrist Robert Lytton, author of *Destroying the World to Save It* and an expert on the effects of the atomic bomb on Hiroshima, "there is a new and painful sense of vulnerability" here.

For many companies, the attack has added to the arguments for moving some or all of their operations out of the city. The securities industry, which accounts for 5% of the city's jobs but 19% of its salary base, was hardest hit by the attack. These companies had already begun to shift jobs out of the city, in part to get away from high rents. Banking giant J.P. Morgan Chase Co., for example, had opened opera-

tions in Delaware, Florida, and Texas. Now, with the sudden loss of 30 million square feet of prime New York real estate, many more firms have moved across the river to New Jersey, and elsewhere, fueling worries that they won't be returning.

That would be a great blow to New York, which relies heavily on taxes from the industry. According to New York State Comptroller H. Carl McCall, the city has become increasingly dependent on the securities industry over the past eight years. Between 1992, when the last recession ended, and 2001, the securities industry climbed from 13% of total city wages to 19%, notes McCall, even while the number of jobs grew only modestly. McCall calculates that the industry has been responsible for nearly one-quarter of the increase in all of the city's tax revenues since 1992, excluding real estate taxes.

TOP TALENT. Still, many argue that New York will remain the epicenter of world finance. The believers say that the city will continue to be a mecca for the hard-working and ambitious and that firms wanting to attract the top talent will need to be here. Take the New York Board of Trade. The group, which trades \$60 billion worth of cocoa, orange juice, and other commodities each year, had been housed in the now-collapsed 4 World Trade Center. Now, it's temporarily ensconced in a disaster-relief facility in Long Island City, in Queens, but is negotiating for permanent space in the New York Mercan-

FACE TO FACE

Many see the urban revival continuing: Human interaction of the best and brightest is what matters

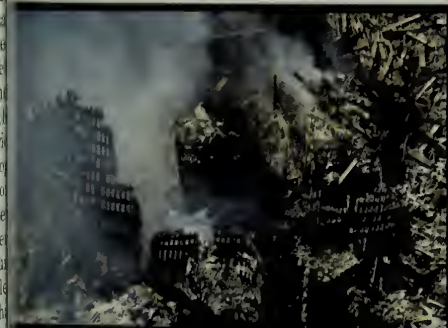
tile Exchange. Others maintain that, while certain functions may in time migrate out of the city, New York will remain a financial hub. "There's a logic to having [people in close] proximity," says Morgan Stanley President Robert G. Scott. "Modern-day communications make that less necessary—but I think you'll still have a financial district."

That belief—that in a wired world, human interaction with the best and brightest still matters—is what the future of New York and other urban cen-

ters will hinge on. Even though computer and telecommunications technology have made remote work possible for a decade or more, urbanists note that cities with their concentrated populations have continued to prosper. At a time of labor scarcity, businesses want to be where their workers want to live, and younger workers crave the excitement and variety of cities. Tech companies benefit from proximity to universities and research hospitals. The economy has continued its shift to more and more knowledge-based activities—and the contacts fostered by cities are a great stimulus for new ideas.

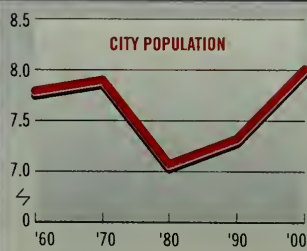
Some see New York's future downtown as a somewhat contracted financial district populated by companies that need to be near one another and their specialized work force, complemented by a mix of other industries, residential buildings, and retail. University of Chicago historian Neil Harris sees parallels with the 1871 Chicago Fire, in which one-third of the city was destroyed. In the aftermath, a new school of architecture sprang up, which created steel-frame skyscrapers and later gave opportunities to young architects such as Frank Lloyd Wright. And for vitality and creativity, it's hard to beat a great city like New York. "Historically, awful things have always happened in cities, which you would have thought would discourage people from living there," says Witold Rybczynski, Meyerson Professor of Urbanism at the University of Pennsylvania. "What's so striking is that it doesn't really stop anybody. They come back and rebuild."

By Nanette Byrnes with Michelle Conlin and Gerry Khermouch in New York and bureau reports



LONG SLOG Reconstruction may take five to seven years—and \$10 billion

WILL TERRORISTS HURT NEW YORK'S REBOUND?



DESIGN

'WE'RE NOT GOING TO LIVE IN BUNKERS'

But airports and office buildings face big changes

The World Trade Center carnage almost certainly will mark the end of America's decades-long infatuation with 80- and 100-story trophy buildings.

Other design and construction implications are harder to sort out. Architects expect, of course, that security issues will become a higher priority in designing buildings and other facilities. But they also warn that a rush to install blast shields, eliminate windows, and truncate entrances may not only breed a false sense of security but also undermine the very institutions people seek to protect. You can expect a "hell of a debate" on that issue, predicts Stuart L. Knoop of Oudens & Knoop Architects in Chevy Chase, Md.

For one thing, architecture and engineering are not up to the challenge of neutralizing the horrific impact of a fuel-laden wide-body jet. "There's no way short of burying the structure to protect against this sort of attack," says Robert Prieto, chairman of engineering giant Parsons Brinckerhoff Inc. Until the twin crashes, the World Trade Center had been considered one of the most secure complexes in the world.

MARKETING PROBLEM. The disaster could make it much harder to market commercial or residential towers taller than 30 or 40 stories. Those now under construction will likely be completed, but there may be no further groundbreakings as potential clients reevaluate the risks of occupying them and coverage dries up following insurers' massive outlays for the Sept. 11 destruction.

Meanwhile, security and evacuation systems are sure to become a more critical part of planning. Lobbies will be enlarged to accommodate enhanced security functions, adjacent or underground parking areas will be avoided, and more attention will be paid to engineering upgrades such as fireproofing structural steel. Unless panic over these issues becomes extreme, though, designers are unlikely to cancel windows,

drastically narrow entryways, and otherwise transform urban buildings into fortresses. Indeed, the evolution of more "transparent" buildings that encourage people to congregate is a key reason cities have become more livable in recent years, says A. Eugene Kohn, president of architecture firm Kohn Pedersen Fox Associates.

Newer techniques and materials are likely to play a larger role in building design. Architects are already moving toward greater use of shatter-resistant glass coverings, foam rather than water-based sprinkler systems, and synthetic textiles to reinforce concrete

columns. The military has begun share security ideas with civilian builders as well. Sandia National Laboratories, for example, has developed entryways that detect explosives and biochemical weapons.

When it comes to high-rises, U.S. developers may look to Asia, where building codes are often more stringent, even though it may mean sacrificing some leasable space. The 95-story Shanghai World Financial Center has fireproofed "refuge" floor every 15 stories to buy time for evacuees in an emergency, says Kohn, whose firm designed the center. Special elevators in the core allow firefighters to haul equipment up without interfering with the exodus of evacuees.

NEW SCRUTINY. Transportation facilities, particularly airports, are certain to undergo intense scrutiny. Air terminals that were designed with downsized check-in areas as fliers gravitated to curbside check-in will be reconfigured. Major airports that have become full-fledged shopping malls will more sharply demarcate secure zones. These new security demands may prompt cash-strapped airlines to rethink the

lines to rethink the push of recent years to construct their own terminals.

Given how the World Trade Center collapse immediately took out adjacent transportation, power, and communications systems, builder Prieto expects pressure on planners to pay more attention to how new buildings will mesh with the surrounding infrastructure.

Still, engineering-driven solutions can only take us so far. "We're not going to live in bunkers," says En Heimsath, an Austin (Tex.) architect. "What's what's superimposed beyond what's natural for the culture, then the people factor kicks in. You install security shields—and guys pop open the back door." The challenge will be to avoid building vats without compromising safety.

By Gerry Kohn, with Robert McNatt, in New York

A NEW WORLD FOR DESIGNERS

Some likely implications of the terrorist attacks

PROLIFERATING BARRIERS Expect a rush to install Jersey barriers, bollards, and other protective barriers.

HIGH-RISE HALT At least in the short term, groundbreakings will stop as insurance dries up and marketing becomes a challenge.

TRANSPORTATION TIGHTENING Extensive reconfigurations of transportation terminals will feature greater space for security, less fluid passenger movement, and a sharper demarcation between pre- and post-security zones.

NEW MATERIALS Designers will be more receptive to using foam-based sprinkler systems, geotextiles to reinforce concrete pillars, and other innovations.



By Bruce Nussbaum

REAL MASTERS OF THE UNIVERSE

A subtle shift in the American zeitgeist took place on Sept. 11. It's hard to define, and it may not last. But on the day of the World Trade Center cataclysm, the country changed. Big, beefy working-class guys became heroes once again, replacing the telegenic financial analysts and techno-billionaires who once had held the nation in thrall. Uniforms and public service became "in." Real sacrifice and real courage were on graphic display.

Maybe it was the class reversals that were so revealing. Men and women making 40 grand a year working for the city responding—risking their own lives—to save investment bankers and traders making 10 times that amount. And dying by the hundreds for the effort. The image of self-sacrifice by civil servants in uniform was simply breathtaking.

For Americans conditioned in the '90s to think of oneself first, to be rich above all else, to accumulate all the good material things, to take safety and security for granted, this was a new reality. So was the contrast of genuine bravery to the faux values of reality TV shows such as *Survivor*.

SEA OF FLAGS. Noteworthy, too, was America's quick return to family, community, church, and patriotism in the aftermath of the tragedy. People became polite and generous to one another without prodding. On that day and the days that followed, they told their wives and husbands and children and parents and significant others they loved them. And the flags, the sea of flags that appeared out of nowhere and spread everywhere, worn by business-suited managers and eyebrow-pierced, tattooed teenagers. As if by magic, city taxicabs, building canopies, and nearly every truck in sight were flying flags.

The offerings of food, money, and blood were overwhelming. The generosity was unsurpassed in our memories. But the manner in which perfect strangers went out of their way to help one another in all kinds of situations was most amazing. To the surprise of its residents, New York became a small-town community. The day-to-day antagonisms among the citizenry melted away.



WORKING-CLASS HEROES *Traditional values have eclipsed the me-now attitude—at least for now*

The rush to church, synagogue, and, yes, mosque was equally unusual. People returned to their religious ceremonies and congregations in huge numbers for support and guidance. The overflow at the doors demonstrated that many who had not visited in years showed up to participate in the familiar and comforting liturgies of their childhoods. They joined with their neighbors in mourning.

LESSONS TAUGHT. It was, for a moment, an old America peeking out from behind the new, me-now America. We saw a glimpse of a country of shared values, not competing interest groups; of common cause, not hateful opposition. There were a few exceptions: Jerry Falwell declaring we brought the death and destruction down on ourselves because of homosexuality, abortion, and the American Civil Liberties Union. A silly, stupid comment to be dismissed in light of the comity of the day—but an extremist remark nonetheless

made in the name of God. How sad.

Tragedy has the power to transform us. But rarely is the transformation permanent. People and societies revert back to the norm. But what is the "norm" for America? Where are this nation's true values? Have we stripped too much away in recent years in order to make us lean and mean for the race to riches? It is hard to look at the images of the World Trade Center rescue again and again. At least once, however, we should look at what the rescuers are teaching us, about what matters—and who.

Nussbaum is Editorial Page Editor.

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Who Gets Hurt
As Corporate VC
Money Dries Up

WEB SMART
Dos & Don'ts
Of the Online
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The New Netpreneurs

Forget Internet heroics.
These folks are building
businesses brick by brick



Brooks

"Like many traditional businesses, our client was not taking full advantage of the Internet. We helped get them out of their single-channel rut and into a multi-channel system. Now they're doing serious business on the web, through their catalog, and in their stores — all seamlessly."

— Steve Wagner, *e-Business Services*



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They're back, chastened, and vowing that this time they'll build companies out of bricks rather than straw. Among the crucial lessons they've learned: Don't try to overthrow the powers that be. Raise smaller dollops of venture capital. Concentrate on engineering rather than marketing. And—believe it or not—don't rush to take the company public before it's ready

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The British supermarket chain has turned itself into the world's top online grocer



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They'll Miss Webvan

Think the collapse of Webvan was tough for its stockholders to swallow? Tell that to Glenn Ruley, food resource manager of the Alameda County Community Food Bank in Northern California. Whatever its financial missteps, Webvan delivered for Oakland's poor: 10% of the food donated last year, about 1 million pounds of dry goods, produce, and meat, came from the now-bankrupt online grocer. "Webvan's fall has had a very dramatic impact on us," Ruley says. Shareholders know the feeling.

Now Ruley is scrambling to fill the donation gap. He plans to turn to supermarket chains such as Safeway, which already is a large donor, and to local restaurants for more food. With the tech downturn pushing the unemployment rate skyward, he may need all the help he can get. —Linda Himelstein



Texas' Power Play

Silicon Valley and Texas are no strangers to tech industry battles, but California's power crunch is lending their spitball wars new juice. A recent survey found that 17% of Valley companies might leave if energy woes worsen. Now, Texas development officials are planning a Sept. 24 tour of San Jose to lure firms to the Lone Star State. Their bait: cheap Texas power. "They hate us," chortles Saralee Tiede, vice-president of Austin's Chamber of Commerce.

Just see if geeks will move from the land of hot technology and culture to the land of hot weather, shoots back Ken Heiman of the San Jose Silicon Valley Chamber. Golden Staters are taking their own small revenge: More than 20,000 people have visited a Web page at Bay Area portal sfgate.com that lets users click off the lights of a virtual Austin skyline. Children, can't we play nicely? —Andrew Park



Strong Words. Tasty, Too

Venture capitalist John Doerr recently apologized for once calling the Internet "the largest legal creation of wealth in the history of the planet." He wasn't alone in his hyperbolic estimation of the Net.

THE PLAYER:

Geoff Yang,
venture capitalist,
Redpoint Ventures



THE QUOTE:

On venture-capital investments: "What risk? If the company doesn't work out, we'll sell it for \$150 million. If the company kind of works out, we'll sell it for \$500 million. And if it really works out, it'll be worth between \$2 billion and \$10 billion." December, 1999

THE REALITY:

Says Yang: "The world has changed. Have you noticed that Juniper's at \$12.50?"

THE PLAYER:

Heidi Miller,
ex-CFO,
Priceline.com



THE QUOTE:

"I believe Priceline can be a huge global company, as big as Citi[group]." February, 2000

THE REALITY:

Miller left Citi's CFO gig for Priceline.com, which today is less than 2% the size of Citigroup. Eight months later, she left for insurance broker Marsh & McLennan, and declines comment.

THE PLAYER:

David Beirne,
venture capitalist,
Webvan Director



THE QUOTE:

"Every Webvan distribution center goes cash-flow-positive five quarters after we open it." June, 2000

THE REALITY:

The grocery delivery company went bust. Worse, when Beirne said this, no Webvan warehouse had been open for five quarters. Says Beirne today: "It still feels like it was a reasonable assumption at the time."

THE PLAYER:

Robert Bernard,
ex-CEO,
marchFirst



THE QUOTE:

"A massive opportunity for Internet professional services is about to hit, and our organization [will be] the dominant leader in this marketplace, bar none, beginning in" 2000. December, 1999.

THE REALITY:

Bernard didn't mention 2001—when marchFirst went bust. Today, Bernard declines to comment.

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BY ELLEN NEUBORNE

ellen_neuborne@ebiz.businessweek.com



Stop the Zzz-mails

Overcautious online advertisers are putting potential customers to sleep

There's an e-mail ad from Amazon.com Inc. in my box. I haven't opened it, but I know what it says. By heart. "Dear Amazon.com customer. As someone who's purchased books in the past, you might be interested to learn blah blah blah zzz zzz." I'm bored just thinking about it. And it's not only Amazon. There's a lot of caution going on in e-mail marketing these days. Advertisers, hoping not to

offend customers who agree to receive their messages, have retreated to safe online communications: Repetitive scripts. Snoozer subject lines. Uninspiring offers. Even marketers with offline moxie get shy in e-mail. On TV, Victoria's Secret has a provocative ad showing a scantily clad beauty doing a chair dance. The concurrent online campaign: "Shop now and save on Body by Victoria." My Sunday coupons have more sex appeal.

Marketers should be worried about my boredom, because I'm far from alone. Last year, 54% of consumers surveyed by Forrester Research Inc. said e-mail was a great way to find out about new products and services. In 2001, that number dropped to 43%. Last year, 21% said they deleted most e-mail ads without reading them. This year, it's up to 36%, and sales resulting from e-mail have fallen by half. A lot of eyeballs are glazing over, says Forrester analyst Shar VanBoskirk. "There is room for more creativity," she adds. But most marketers don't get it. More than 70% of those using e-mail rely primarily on plain text.

A few brave ones are trying to rise above the polite whisper. Take Reflect.com, an online beauty store. Instead of plain-vanilla e-mail, Reflect customers who abandon items in a virtual shopping cart get a note pushing that product, or even a picture of it with the shopper's name on the label. Reflect has always used e-mail ads. But the personalized e-mail pitches doubled the company's conversion rate of shoppers to buyers, says Hannelore Schmidt, Reflect's customer relations manager.

Other companies have seen similar responses to e-mail creativity. Restaurant-guide company Zagat Survey tripled its e-mail ad response rate by letting customers buy its books via a

simple link in the e-mail. Drexel Heritage sent out a message with high-quality photography of its furniture and reaped a click-through rate of 21%—far better than the industry average of 5%. Other tactics might include interactive games or surveys, says Dor Peppers, founding partner of customer relationship consultancy Peppers & Rogers Group. "You want to encourage a response, an interaction," he says. "Most companies are not scratching the surface of what's possible."

Advertisers should be careful to avoid overloading customers' computers and Net connections. The Direct Marketing Assn., the trade group for catalog companies, wandered into that minefield. The group sent out an e-mail promotion featuring music and full-motion video. Some recipients complained that the message set off security warnings and then crashed before delivering all of its information. That sort of experience keeps other potentially lively e-mail on the drawing boards. Fairytale Brownies, a gourmet food seller, did an e-mail promotion linked to the hit movie *Shrek*. While the food company considered animation in the campaign, it settled

for a still photo of the main character out of fear that it might annoy customers with older equipment, says President Eileen Spitalny. "We worry over the e-mails quite a bit. These are our best customers." You need to be careful, she says.

But not paralyzed. E-mail marketing is close to stalling in state of dullness. You may have a great offer, a great message, a great product, but you won't get a nibble if your ad campaign is a snooze. Consumers will read intriguing e-mail. Marketers, though, shouldn't expect much from a safe, boring message. Don't be afraid to get our attention. It's better than a lullaby.





TODAY

Lou's in control at Cisco Systems.

YESTERDAY

His life was one big zoo.



It's another typical Monday for **Lou Mc Elwain** in Singapore. As Cisco Systems' Vice President for Sales Operations in Asia Pacific, he's **on top** of what's happening in the region, just as he always is. But yesterday? Well, that was different. Yesterday, Lou's life was one big zoo. And he and his **family** loved it. You see, **Singapore** offers much more than Asia's best IT infrastructure. As well as being Asia's most **connected** city, it's also a **great** place to live. There's a vibrant arts scene, a **superb** symphony orchestra, any number of gourmet restaurants and, as Lou will testify, one of the most beautiful **zoos** in the world.

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BY ROGER O. CROCKETT

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Give Your Site Kid-Appeal

Children often decide where parents shop—and how long they stick around

The red dress with white polka dots and bloomers that Kimberly D. Majors saw online didn't excite her. But Majors, a U.S. Marine Corps master sergeant from Jacksonville, N.C., wasn't buying for herself. She was shopping for daughters Gabrielle, 2, and Janel, 4. And the girls loved what they saw. "Ooh" they shouted as they pointed to the dress on Gapkids.com. "We want that." So she dropped two of the

\$30 outfits into her virtual shopping cart. "For some reason, that dress struck a chord with the kids," Majors says.

Make no mistake, kids dig cybershopping. Sure, young children—from toddlers to preteens—aren't always proficient readers. And few, if any, have credit cards for online purchases. Yet they have clout. Some 84% of Netizens say they enjoy going online with their children, according to researcher Cyber Dialogue Inc. And many of those are "Web-wise Moms." Cyberstores, take note: These moms average 18 hours a week online and \$62,500 in income, 27% higher than the typical Net consumer.

Some parents even let the kids do the driving. A study by researcher NFO WorldGroup Inc. found that three-fourths of parents who plan to shop online for their kids this fall will let the children participate: Nearly half allow kids to point and click their way across the Web, and 42% say their children suggest sites they should visit. "Kids play a huge role in what their parents are getting online," says Zain Raj, president of FCBI, the interactive marketing arm of ad agency Foote, Cone & Belding.

Yet many e-tailers aren't taking full advantage of that. Strangely, most neglect to incorporate basic features that attract kids: games, animation, flashy graphics, sound. Consider Guess. It's a popular clothing brand among kids, yet its Web site offers little that speaks to them. Guess.com is "all static content," says senior analyst Melissa P. Grimes of Cyber Dialogue. "There's nothing to engage children." Guess declined to comment. But it and other e-tailers might follow the lead of cereal makers: They decorate products with cartoons to attract kids in the shopping cart as parents cruise grocery aisles. The cyber-aisle is no different.

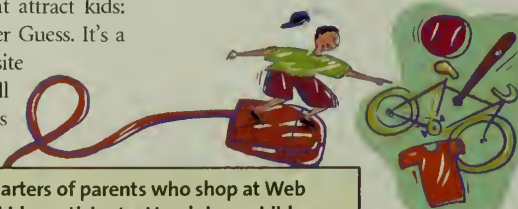
Some children's sites get it. Even though adults do the buying, Disney.com is a toddler's dream—filled with images of Mickey and other Disney characters and sounds of a xylophone. "Move the mouse, move the mouse," demand Majors' daughters, who like to visit the site several times a week. Disney's formula has made it the top kids' site on the Net, with 6.2 million unique visitors in August—five times the traffic of Nick Jr.com, its closest competitor. "We've created something special and unique: The integration of commerce for adults and entertainment for kids," says Kenneth F. Goldstein, managing director for Disney Online.

This doesn't necessarily mean that every family-oriented e-tailer should remake itself into a noisy kids' site. For merchants selling children's products, though, a dab of color and creativity can certainly boost traffic. Target.com revamped its site this summer to appeal to the young (page EB34). It features gyrating orange circles and disappearing squares to capture kids' attention. A "wish list" that lets children identify gifts they want and e-mail the items to parents has been added to boost sales during the upcoming holiday season. More than 100,000 users have

signed up since the feature was launched in August, says Catherine A. David, general manager of Target.com. Meanwhile, the site has watched its traffic jump from 2.4 million visitors

in June, when the kid-friendly features were introduced, to 3.1 million visitors in August. "We recognize how big the role of up-and-coming shoppers is," David says.

With the holiday buying season around the corner, this may be a good time to inject a little kid-appeal into your site. •



Kids Know Best

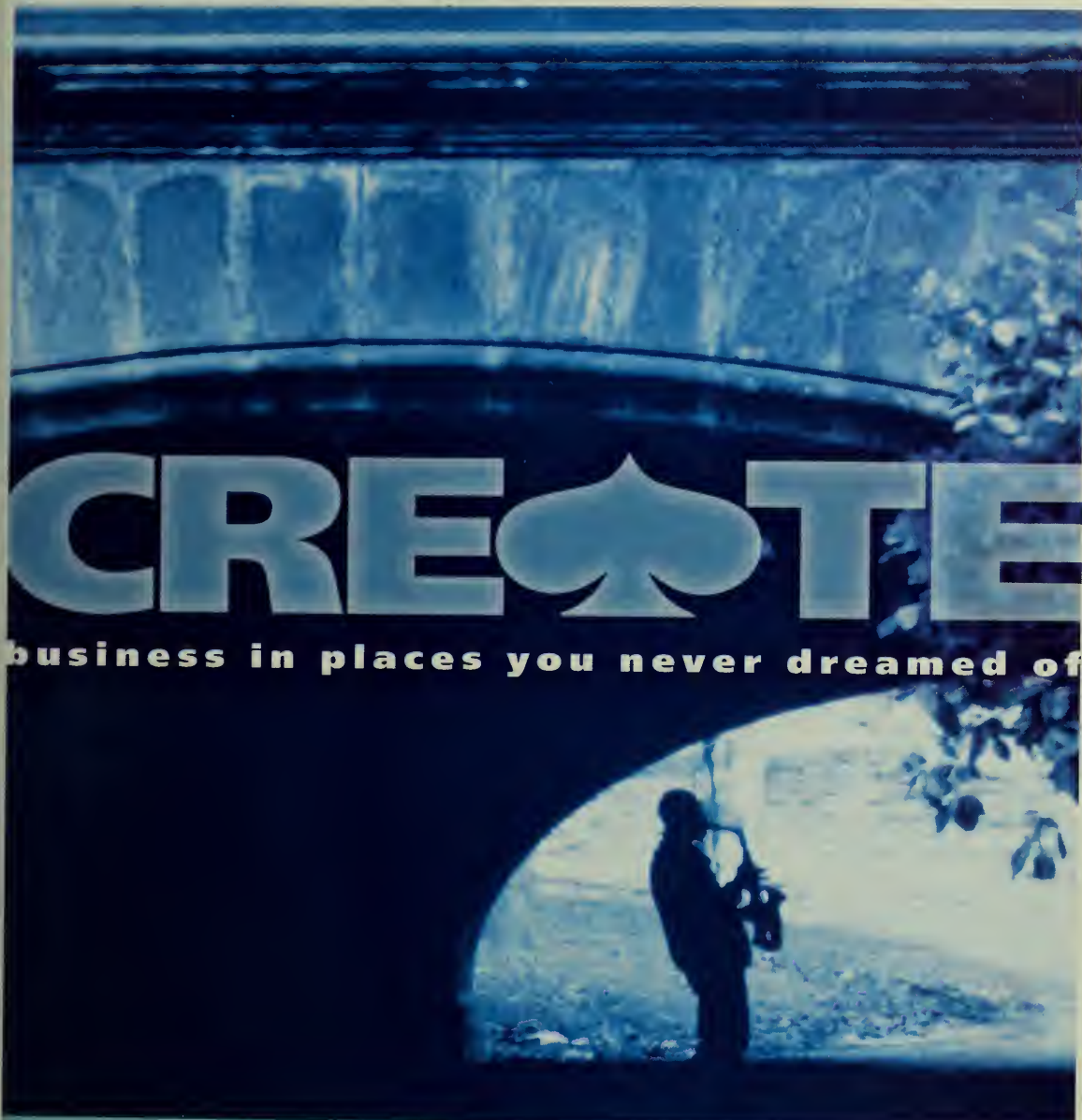
Nearly three-quarters of parents who shop at Web stores let their kids participate. Here's how children influence their parents' online buying decisions:

Parents who let children...

POINT AND CLICK	48%
SUGGEST WEB SITES	42%
GUIDE POINT-AND-CLICK PROCESS	34%
PARTICIPATE IN CHECK-OUT	33%

(Parents could give more than one response, so total does not add up to 100%.)

Data: NFO WorldGroup



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BY TIMOTHY J. MULLANEY

tim_mullaney@ebiz.businessweek.com

XP: Not Too Xciting

The new Windows has nice dressing, but it won't wow the Web

Microsoft is a software maker to the bone. It doesn't have a service mentality. So it sometimes overlooks practical considerations, such as the fact that most people still take photos with old-fashioned cameras, not digital ones. And that helps explain why the Internet features that will come packaged next month with Microsoft's Windows XP will be a good addition to Web surfing, but not a transformative one.

Part of the buzz about XP has been that it improves the integration of an operating system with online services, such as personal Web-page publishing and photo services, and makes it easier to build home networks that tap everybody in your house into the Net. A few of these services, especially Microsoft's integration of XP with the personal home-page publishing section of the MSN portal, are easy to use and versatile. But most are only modest improvements, at best, over what's already out there.

First, let's talk about the good stuff. My favorite thing about XP is how easy it makes building a Web page on its MSN portal that combines text, pictures, and music. Microsoft has simplified it to a five-step process easily accessible from the start page, similar to the click-here programs we all know from installing new software.

Microsoft's Passport personal-information manager existed before XP, but, like the company's browser and media-player applications, which can both be downloaded separately, it has

now been built into the heart of the operating system. Passport is a minor timesaver. You type in your personal data. Then, when you go on the Net, you sign in once and don't have to remember a password for each Web site. And, if you chose to add credit-card and mailing information, you can buy items on participating Web sites without retyping all of that.

But this level of convenience is an exception. Take XP's online photo service. The new operating system contains direct links to two different online photo-service providers—Eastman Kodak Co. and Fuji Photo Film Co. Both links only let you upload your digital photos to the Web, edit them, and order prints. Neither handles traditional film processing, as a raft of online services do. Since most consumers still use film cameras rather than digital, that's a major omission. Microsoft should offer services that provide traditional film developing before XP ships in October—something the company says it's considering.

Microsoft also comes up short when it tries to simplify home networking. It has built a perfectly decent wizard—again, good software—to guide folks through the process of connecting PCs in their homes so they can share a single Internet connection. The problem? You're faced with a 12-step set of instructions that calls for mapping out a network and identifying what hubs, modems, and adapters you need to connect the PCs. My advice: Hire a pro. Microsoft could help by creating an online directory of local outfits that can install the networks.

When it comes to downloading music off the Web, Windows XP doesn't do much. Its My Music feature takes you to the extremely limited music-download offerings of WindowsMedia.com.

There's a lot to like about XP. It doesn't crash very often, for instance. But until Microsoft learns how to deliver rich Web services to consumers, its operating system will continue to be less than it could be. ●



A Mixed Bag from Microsoft

Windows XP sure looks nice. And it crashes less often than the Windows Me it replaces. But its Web features are just average.



Photos: XP offers access to selected photo finishers. But those services offer only reprints of digital shots, not conventional film processing.



Personal Publishing: Integration among XP and Microsoft's MSN Communities lets you build home pages easily. XP could help MSN compete with Yahoo!'s GeoCities community.



Home Networking: XP lets you make one PC in your home the hub of a network. That lets you share Net access, which saves bucks. But you may need a pro to set up XP's home networking.



- 1 This is the **CUSTOMER**
- 2 That accessed the **Account**
- 3 That linked with the **Database**
- 4 That verified the **Deposit**
- 5 That released the **Funds**
- 6 That paid the **Loan**
- 7 That updated the **Records**
- 8 That triggered the **Statement**
- 9 That completed the **Process**
- 10 That lives in the **Integration Software**
- 11 That we **Built**.

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The New Netrepreneurs

Dot-com veterans are creating smarter startups for a chastened world

Like thousands of other Internet entrepreneurs, Ashfaq A. Munshi lost his head at the dot-com party. He had held management jobs at old-line tech companies, including Silicon Graphics Inc., but in 1996, he took the startup plunge—co-founding three e-commerce companies in quick succession. His highest hopes were for SpecialtyMD.com, a medical e-marketplace where he was CEO. When Internet medical pioneer Healtheon Corp. went public in February, 1999, and its price zoomed to \$105 a share, Munshi became obsessed. He had previously worked with several of Healtheon's founders. Suddenly, all he thought about was selling out or going public. He needed to prove that he, too, could become fabulously wealthy practically overnight—he was just as smart as the billionaire next door.

It was his wife, Ruma, who made him take a hard look at himself. One night in the summer of 1999, she told him he had turned into the greedy person he had vowed he would never become. At first, Munshi denied it, but within days, he realized she spoke the truth. Shook up, he started operating differently—building the company for the long haul. Ultimately, he sold SpecialtyMD.com for

\$110 million. After the deal closed, the emotional impact of operating for years at mind-frazzling speed sank in. He had bottled up the thrills, tension, greed, and guilt of the Internet boom. During a religious retreat, Munshi broke down and wept. "I have never cried that long and deeply before," he recalls. "Everything I had pent up came out."

That roller coaster is just a dizzying memory now. These days, a

startup's prospects are no longer the same—and neither is Ash Munshi. He's still creating Net companies. In fact, he has two under way: Radiance Technologies, which speeds the flow of information on the Web, and Vivecon Corp., which streamlines companies' dealings with their suppliers. But today, he's

ASHFAQ MUNSHI CEO, RADIANCE TECHNOLOGIES

► **His past:** After holding management jobs at several tech companies, starting in 1996, he co-founded three startups, including SpecialtyMD.com, which was sold for \$110 million.

► **The present:** Runs Radiance, a software company that speeds the flow of information on the Net.

► **What's different?** In the dot-com heyday, Munshi got swept up in the rush to cash out and lost his focus on business fundamentals. Now, he's building for the long haul.

Photographs by ericmillet.com



doing things differently. At Radiance, Munshi spent a parsimonious \$4 million in the first year of operations. Rather than scheming to get rich quick, he's creating technology that solves acute problems for corporations. And he's managing companies to make profits—now. "It's back to the old way," says Munshi.

That's the mantra of second-generation Internet entrepreneurs. They're back, chastened, and vowing to build companies out of bricks rather than straw. It has been 18 months since the dot-com meltdown began, and the first stirrings of Webland rebirth have begun. Dozens of Net veterans are laboring in obscurity—targeting everything from wireless communications to software for corporate supply chains. They're convinced that the Internet phenomenon is still in its infancy. And they aim to take the mistakes of the past and turn them into advantages for the future. "The opportunity to build a business around the Internet is as big as it ever was, but the means for pursuing it have returned to rationality," says Mike Homer, a former senior executive at browser pioneer Netscape Communications Corp. who is now CEO of Kontiki, a startup that moves video across the Net.

These entrepreneurs are consulting a new playbook. Rather than betting on

ideas aimed at overthrowing the powers that be, they're providing the tools that help established corporations do business more efficiently. They're raising venture-capital money in smaller dollops—\$2 million rather than \$10 million. They're concentrating on engineering rather than marketing: Some startups won't hire a sales boss until they have a product ready for launch. And they're not planning on going public anytime soon. Instead, some vow they'll put that off for ages. They plan to build mature companies before they open themselves to fickle public markets.

At the same time, they're sticking with the best strategies they learned during the boom. They're engineering products differently—often creating services delivered on the Web rather than traditional software. And, trained to operate on Internet time, they're ready and able to change directions in an instant if a new strategy is required. Good thing, too: The uncertain economic climate has made the demand for products as changeable as the weather. Consider Steve Kirsch, a co-founder of Web portal Infoseek and now CEO of Propel Software Corp. In May, he abruptly abandoned his plan for developing e-commerce software because the field was too crowded. He switched to creat-

ing software that makes massive databases operate smoothly when they're queried by thousands of people at once. "Agility and nimbleness are even more important to startups than they were in the past," says George Foster, a management professor at Stanford University.

Because they have been through boom times as well as the bust, these second-timers have a leg up on new entrepreneurs. Venture capitalists are willing to back people who have made their mistakes and learned from them. "In Silicon Valley, failure is forgiven—as long as you're a technologist," says Guy Kawasaki, CEO of Garage Technology Ventures, a consultant to startups. Even uncertainty about where the industry is headed is an advantage for these Net vets. They have the ability to sort through tech trends and spot where the next opportunities lie. "The true entrepreneur wants confusion. He wants to get started before others figure things out," says John L. Nesheim, author of the book *High Tech Startup*. "These are wonderful conditions for entrepreneurs—if they apply the lessons of the past."

But have these entrepreneurs really changed their stripes? Sure, they've made their vows of sobriety. But the harsh economy could be credited with their newfound stinginess in spending. When

How They're Adapting to A New World

Internet entrepreneurs have learned from their successes and their mistakes—and are coming up with new ways to win with their second-generation Web startups.



Raising money: In April, 2000, Charles Ferguson founded Juice Software, which makes programs that integrate the Web with PC applications. He put up \$2.5 million from the sale of a previous Net startup and scraped together \$600,000 in other backing. Only after Juice got going could he get venture funding.

Lesson: Even experienced Net entrepreneurs have to scramble. Among those ponying up seed cash: Juice's landlord.



Hiring: With budgets tight, startup salaries for new recruits have dropped nearly 15%. Mike Homer, CEO of video tech company Kontiki, offers workers restricted shares instead of options. The shares are available immediately and offer tax advantages for employees.

Lesson: Don't overpay, but come up with ways to attract and keep the best and brightest workers.

Developing products: In 1996 Net medical pioneer Healtheon rushed a product out in eight months—too fast, says co-founder Kittu Kolluri. At his new company, DanaStreet, which sets up private networks on the Web, Kolluri is taking 18 months to deliver his first product, due in November.



Lesson: Products these days must be rock-solid. Take the time to survey customers and test thoroughly.

the economy and capital markets pick up, they might be tempted to revert to 1999-style practices. Until then, management experts say, it will be hard to tell whether attitudes have fundamentally changed and a build-for-the-long-term philosophy will prevail. "To be frank, I think you would see a lot of craziness again. Some people think this is temporary," says David Morgan, CEO of online-advertising software company True Audience Inc. and former CEO of Web ad pioneer Real Media Inc.

Will the new 'learned-my-lesson, build-for-the-long-term' view hold once capital markets pick up?

When Morgan looks back on Real Media, he sometimes wonders what he could have been thinking. He remembers when, in early 2000, he organized a get-together for the company's staff of 400 at a Greek resort that was going to cost \$800,000. "It was a boondoggle," he admits. When the Nasdaq crashed, he canceled the trip, giving up a \$350,000 deposit. Morgan resigned from Real Media last year, intent on starting a new company that would help advertisers better measure the effect of their online advertising. Now, when Morgan ponders a staff retreat for his crew of nine at True Au-

dience, he doesn't want to sacrifice even a day of productivity. "I wonder if they'd be willing to have a picnic at the office on a Saturday," he says.

Like Morgan, CEOs today have to come up with creative ways to get money, and then even more creative ways to get the job done without spending very much of it. Last year, Narasimha Reddy, an early Netscape employee, started a company code-named Momsdesk.com, a maker of secure e-commerce systems. He decided he would custom-design his

computer applications with information gathered on the Web, laid off seven people from a staff of 50 last fall even though it had \$6 million in the bank. The company had hired prematurely in administration and marketing and decided to trim back amid signs that the economy was weakening, says Chairman Charles H. Ferguson, who was CEO of Vermeer Technologies Inc., a Web-page design-tool company that was sold to Microsoft Corp. for \$130 million in 1996. Juice resumed hiring as its products came closer to their July 30 release. It now has 57 employees and recently raised an additional \$12 million.

All the penny-pinching in the world means nothing, though, if you don't have a sound idea to build a company around. Late in the boom, many were chasing after the latest hot thing—delivering software over the Net as a service, optical networking, or brokering transactions between buyers and sellers via the Web. None of those markets has blossomed yet, though they still have promise. Now, there are few huge, new fields ripe for the picking. So veteran entrepreneurs are doing things the old-fashioned way: Rather than targeting the Next Big Thing, they're focusing on hard-to-do technologies that make corporations more efficient. "Call it a return to nerdism," says Garage's Kawasaki.

Nobody illustrates the shift better than

Selling: As Netscape's technology VP, Mike McCue says he

learned how not to treat customers. Today he's chairman of voice processing startup Tellme and has organized sales and technical

workers into customer satisfaction teams that focus on just a handful of clients.

Lesson: With customers queasy about spending money, go overboard to please them.



Making a profit: Zack Rinat

learned discipline at Web startup Net-Dynamics, which he sold for \$180 million in 1998. Now, as CEO of Model N, a maker of collaboration software, he's so tight with

expenses that he completed two customer installations before hiring a sales chief. Rinat aims to be cash-flow positive in four quarters.

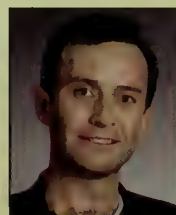
Lesson: Unlike in the old days, profits are the only real yardstick companies are being measured by.



Going public: At David

Morgan's last company, Real Media, new recruits always wanted to know how rich they'd be after the IPO. Now, Morgan, CEO of Web ad software maker True Audience, says he and his employees never discuss going public: It's not part of his business plan.

Lesson: Going public is a potential step along the route to building a company—not the end goal.



Halsey Minor. The founder of CNET Networks Inc., the leading online tech-information company, and Snap.com, a Web portal that was later bought by NBC for a paltry \$5 million, is now CEO of 12 Entrepreneur Inc., a San Francisco holding company that builds tech startups that use the Internet to improve a corporation's internal processes. So far, he has launched Grand Central Networks Inc., which is developing Web services for managing the exchange of information among corporations, and iBuilding, a Web service for handling business tasks for real estate companies. These services are focusing on fundamental business processes—not trying to upend established players in industries. "I think it's very hard for new players to emerge in the media business now," he says.

Minor didn't have any trouble raising money. He bagged \$130 million in May, 2000, before it was clear just how bad this downturn would be. Today, most entrepreneurs are having a difficult time

getting funding. Money for Internet startups has plummeted from \$22.6 billion in the second quarter of 2000 to \$7.3 billion in the second quarter this year, according to Venture Economics. Only 173 early-stage companies got funding last quarter, vs. 625 a year earlier. Now, it often takes six months or more to get initial funding—compared with just weeks in the past. And valuations placed on startups have been cut in half.

Still, new companies with seasoned management teams are getting funded. The key is to focus on the slices of markets that are likely to mature first. SEVEN Networks CEO Bill Nguyen, ex-CEO of Onebox.com, an Internet messaging provider that was sold to Phone.com for \$850 million, was able to raise \$30 million this month on top of \$34 million he raised a year ago. What drew those backers? Nguyen realized that the earliest wireless Web opportunities would come from corporations, not consumers. SEVEN sells software to

telecom carriers who manage wireless networks for corporate clients.

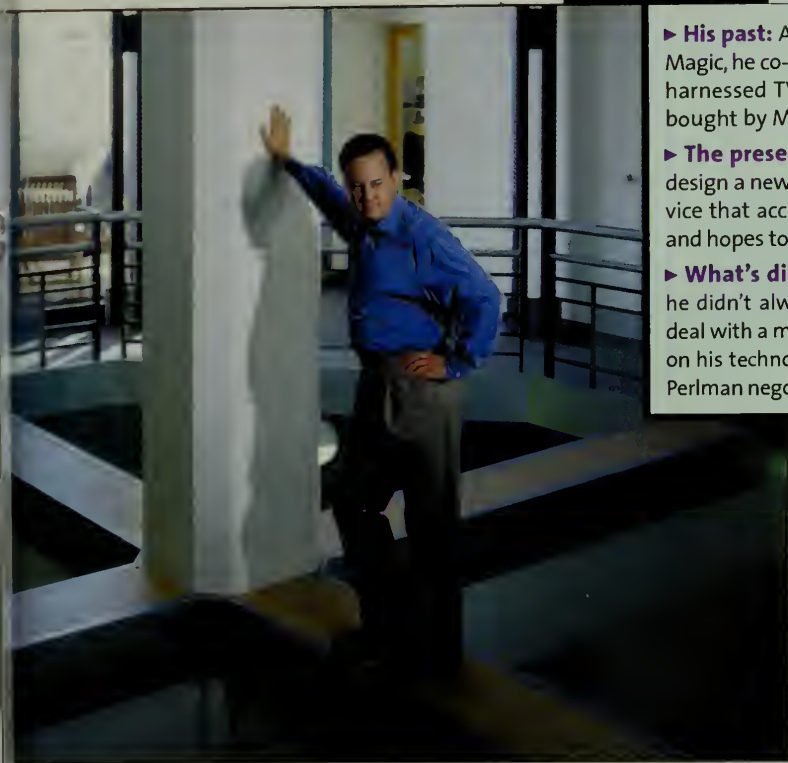
Once startups get their money, every step of the building process proceeds at a more deliberate pace than in the past. At DanaStreet Technologies, CEO and Healtheon veteran Kittu Kolluri expects to take 18 months to deliver his first product, software to quickly create secure Web connections for a company's farflung employees. Compare that with the eight months it took Kolluri and the other founders of Healtheon to deliver their first product—which wasn't polished. Almost all of DanaStreet's 20 engineers are senior people with deep knowledge of networking protocols and security.

To make all that work pay off, companies are aggressively seeking patents. That didn't seem necessary in the earlier Internet days. Back then, the focus was on creating new kinds of businesses and getting there first rather than on building a technology foundation. The U.S. Patent & Trademark Office received 72,526 information-technology and telecom patent applications last year, compared with just 40,576 in 1997. Rearden Steel Technologies Inc., for example, which is developing Net-connected home-entertainment devices, has applied for 44 patents for chips, software, circuit boards, and mechanical engineering. It plans to file 16 more applications as well. "Engineering is important again because it's creating something that's real and something that's hard to do. So it creates barriers to entry by others," says Steve Perlman, Rearden's



HALSEY MINOR CEO, 12 ENTREPRENEURING

- **His past:** Co-founded CNET Networks in 1992 and built it into the online leader in tech news and information. His attempt at a Web portal, Snap.com, was a flop. He left CNET's board last November.
- **The present:** Runs 12 Entrepreneur, a holding company for startups offering Web services. Minor raised \$130 million in venture capital last year and has funded two companies, including Grand Central, which operates communication links among companies and their suppliers.
- **What's different?** Too many new businesses at CNET split the company's focus. At 12 Entrepreneur, each startup is sharply focused, while the holding company takes new ideas and spins them out into new businesses.



► **His past:** After gigs at Apple Computer and General Magic, he co-founded and ran WebTV Networks, which harnessed TV to access the Web. His company was bought by Microsoft for \$425 million in 1997.

► **The present:** Last year, he started Rearden Steel to design a new consumer-electronics entertainment device that accesses the Web. He has raised \$67 million and hopes to come out with a product in the next year.

► **What's different?** At WebTV, he was so rushed that he didn't always make sure deals were solid. An early deal with a midlevel exec at Sony to make devices based on his technology fell through at the last minute. Now, Perlman negotiates with people who have top authority.

CEO, who was a co-founder of Web-access pioneer WebTV, which he sold to Microsoft in 1997 for \$425 million.

As important as engineers are, companies don't have to pay as much to get them these days. In 1999, it was a programmers' market. Software engineers with three or four years' experience could expect to get paid more than \$100,000 and 0.5% of a startup's shares if they joined early enough. Companies can't afford compensation packages like that anymore. Now, CEOs say they can get experienced engineers and marketers for less than \$100,000. And they're no longer giving flextime to everyone who asks.

Once they get engineering under way, startup CEOs are drastically rethinking the way they take on their markets. John K. Peters, CEO of Sigma Networks Inc. and former CEO of Internet service provider Concentric Networks, which was sold to NextLink Communications last year for \$2.9 billion, says he learned from the mistakes of high-speed Net access providers. They blanketed metropolitan areas with their networks and ultimately ran out of cash. Sigma, which provides broadband links between the Internet backbone and high-traffic users, builds out sections of its network only

when specific customers come online. "In the old days, the strategy was: 'Build it, and they will come.' Now, you want to see the whites of their eyes before you build it," says Peters.

There's a new attitude when it comes to running sales, too. Mike McCue, chairman of Tellme Networks Inc., learned how not to treat customers when he was a manager at Netscape. "We were being driven to hit a new revenue target every quarter. We used to do drive-by shootings. We'd go in and get the cash and disappear," he recalls. That post-deal inattention hurt Netscape's long-term relationships with customers. In some cases, the company even had to give money back to disgruntled buyers. At Tellme, which started in 1999, McCue focuses on a handful of telecom and airline companies, hoping to get them to buy more of his voice-recognition services each year. This summer, he reorganized the 195-employee company into customer-satisfaction teams made up of sales and technical people, each responsible for a few accounts. "We have plenty of money—\$150 million. But if we run out of customer goodwill, we're dead," says McCue.

In the go-go days, strategic partner-

ships were vital but often ill-conceived. Perry Friedman, a co-founder of Digital Envoy, a Web marketing technology company, recalls that when he was vice-president for engineering at Internet Sports Network, the company forged partnerships that made no sense to him. ISN, which he left two years ago and which ceased operations last year, created sports contests for its own and other companies' Web sites. He cites a December, 1999, pact with SportsLine.com Inc. in which ISN got its name on CBS SportsLine and other Web sites, lifting its profile with consumers. But it agreed to pay SportsLine.com \$17 million over four years for the honor of running contests on those Web sites. Friedman believes the investment in building a brand didn't pay off. "The theme of the day was to spend a lot of money and get your name out there. It didn't work," he says. At Digital Envoy, chief technologist Friedman is making deals that bring the company dependable returns. A pact with Web giant AOL Time Warner Inc. includes an investment by AOL in Digital Envoy and its agreement to buy the smaller company's technology.

The slowdown has turned the initial-public-offering world upside down. In the gold-rush days, a quick IPO was a startup's *raison d'être*. Zack Rinat sold his previous startup, NetDynamics, to Sun Microsystems Inc. in 1998 for \$180 million. These days, Zack, now CEO of Model N, a maker of collaboration software, says an IPO rarely crosses his mind. His strategy is to make his company sizable and profitable. Then, if he needs money to expand his business and a public offering seems like the best option, he'll con-

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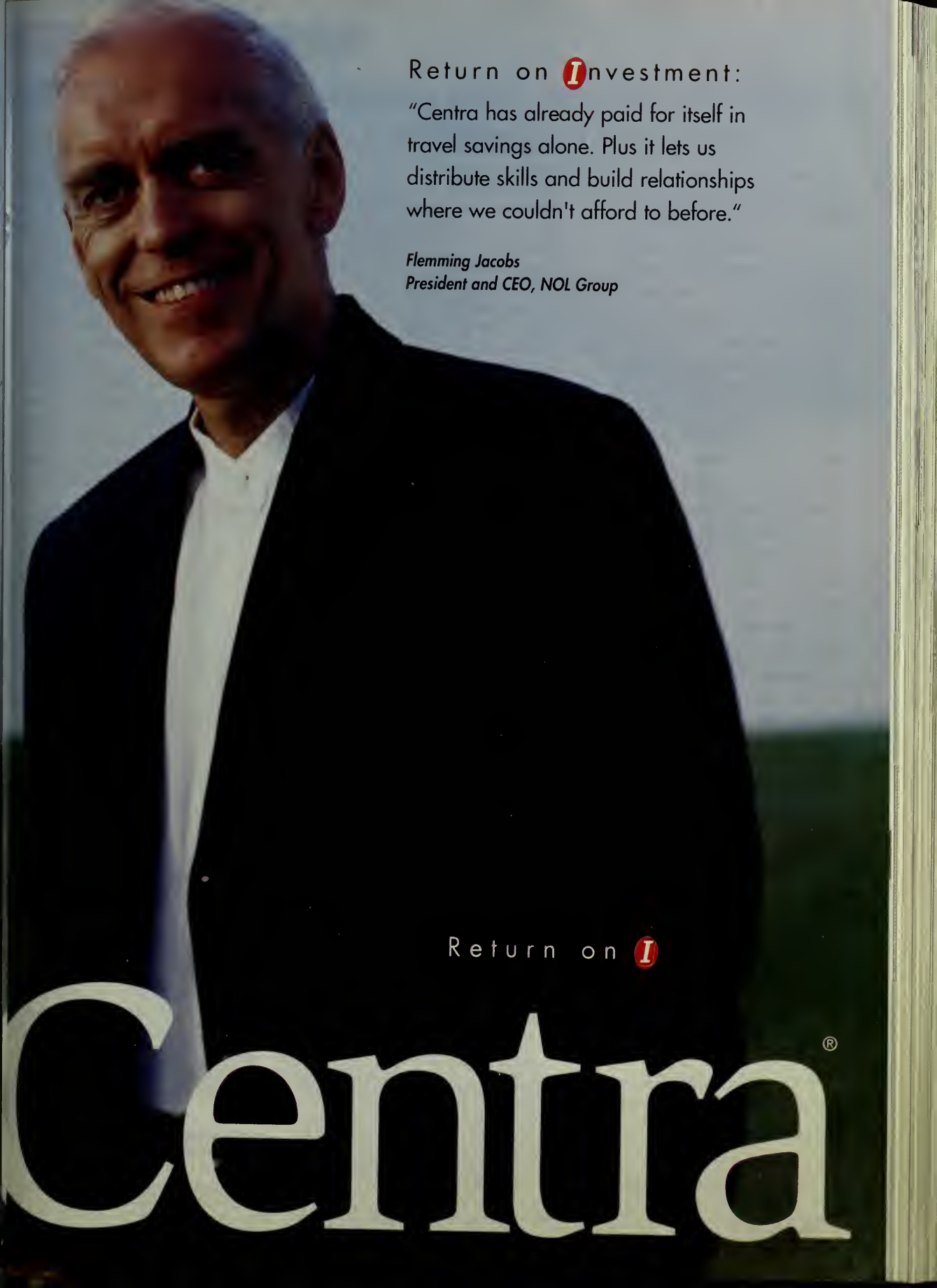
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President and CEO, NOL Group*

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Portals: The Next Wave?

Remember the impact of the electronic calculator on business and consumers in the 70s... the PC in the 80s... or the Web in the 90s? All of these technology innovations dramatically changed the way business was conducted. What technology will have the same impact on the 2000s? Unisys is betting on the portal.

"Portals provide personalized, consolidated, single points of access for all sources of relevant information and software applications," says Terry Hisey, Vice President and General Manager, Portal Practice, Unisys Corporation. "With portals, we are embarking on a fundamentally new way of thinking about the presentation and use of information based on role, organization, and industry. Because of this, portals are poised to transcend the desktop."

The Unisys Portal Practice takes a different approach to the market by linking a customer's business strategy to its portal development. Unisys utilizes the practice's key innovation areas, including experience engineering, community creation and management, in combination with strategic consulting and systems integration to develop and deploy portal solutions designed to facilitate enterprise-wide information sharing and better communication with customers, employees, and partners.

To find out more about Unisys and the Portal Practice, visit: www.aheadforebusiness.com

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sider it. "There's nothing in our core values that says we're going to get rich," says Rinat.

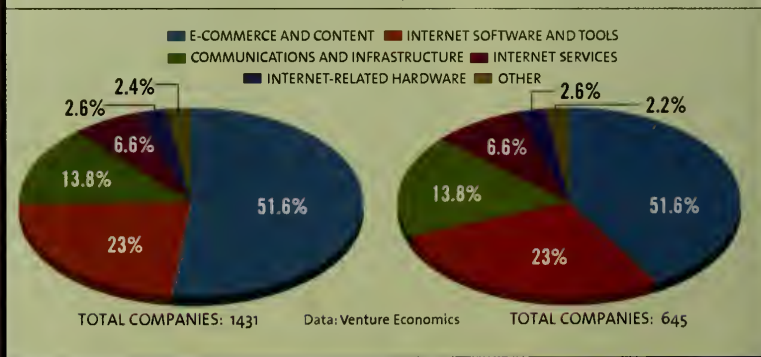
There were plenty of things about dot-com business practices that Net veterans still find immensely valuable. They share information—even bad news—quickly with everybody in their organizations. Engineering managers learned to develop products in new ways on the Net—and those lessons are keepers. Craig Donato, CEO of Grand Central and a former senior vice-president for At Home Corp., found that just because the company's Excite Web site could constantly be improved didn't mean it should be. Making changes every day wore out engineers and meant that the site was never totally reliable. So he came up with a system in which major improvements

hours of the morning after one very long day at Healtheon. He now believes that that way of living and working exhausted both executives and employees—resulting in mistakes. "Now, we work from 9:30 to 5:30. Then we go home," Kolluri says.

Many of the entrepreneurs who helped launch the Internet gold rush dropped out to rest and take stock. Now, they're ready to start new companies. Joe Kraus, a co-founder of Excite Inc., is exploring the possibilities in computer-to-computer interactions—which he expects will make finding information on the Web dramatically easier. Mark Goldstein, who ran e-tailer BlueLight.com LLC, the Web presence for retailer Kmart Corp., wants to create outlets for existing businesses on the Net, just as he did for Kmart.

WHAT'S GETTING FUNDED

Overall, venture investing in Internet-related startups has plummeted, but communications and software have held up better than e-commerce and content.



are spaced out over a number of months, keeping the development staff on an even keel. Now, he's applying that system to Grand Central's round-the-clock services for connecting companies and their suppliers.

For Donato and others, hard times caused them to reexamine their core beliefs and bring balance to their work lives. Donato bought an old gold mine on California's American River and spends his spare time restoring the land with pick and shovel. He believes working with his hands gives him a perspective that will help him make sound decisions as a manager. DanaStreet's Kolluri has banished the old around-the-clock work culture. He remembers falling asleep at a stoplight in the wee

"I'm glad I got to surf the wave. It was a rush. I don't know if the next wave will be as big. But I'm going to try to catch it, too," vows Goldstein.

That's the way it is with serial entrepreneurs: Starting up is a compulsion. Yet for all of the frenetic activity in techdom during the 1990s, no companies of the stature of a Microsoft, Intel, IBM, Oracle, AOL, or Cisco have emerged out of the Internet tumult. Now, we'll get to see if the Net boom's veterans—older and wiser—do a better job the second time around. •

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For a Q & A with Jonathan Feiber, a venture capitalist with Mohr Davidow Ventures, visit ebiz.businessweek.com.

Something unusual happens when we help governments
unify their legacy systems with the future.

A black and white photograph of a man sitting on the floor, leaning back on his hands. Instead of a head, he has a computer monitor. The monitor displays the text "We bring power to the people." The man is wearing a light-colored button-down shirt and dark trousers. The background is a plain, light-colored wall.

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As corporations shut their venture capital arms, they may do themselves damage

The Wrong

Sure, you can blame Comdisco Inc.'s dizzying spiral into bankruptcy on a multitude of management *faux pas*. But the last straw was the red ink flowing from the company's investment arm, Comdisco Ventures. The unit, which halted its investments in January, lost \$149 million in the first half of this year, largely because of stakes in struggling tech startups. Says Morningstar Inc. analyst Terrence K. MacKay: "They were trying to grab hold of the tech gold rush, and it bit them."

More like swallowed them whole. And Comdisco, which filed for Chapter 11 in July, isn't the only company sporting teeth marks on its venture unit. Thanks to the tech downturn, a near-shutdown of the initial public offering market, and now increased economic worries because of the terrorist attacks, scores of corporations that set up venture-capital arms are slamming the brakes on investments. KPMG Consulting folded its venture unit after the firm went public this year. Internet consultant Scient Corp. shut down its venture arm and wrote off all its investments in December. And many more have done the same, says Darrell Rigby, a director at management consultancy Bain & Co. He says a survey of 245 execs with venture funds found that 45% had abandoned those efforts this year. "These are silent shutterings rather than loud proclamations," Rigby says.

Corporate cash may be disappearing with a whisper, but its impact is loud and clear. Granted, overall venture-capital investment is down: It dropped 63% in the first half of this year from the same period in 2000. But investments by corporate venture units in the first half of 2001 plummeted 91% from last year's

levels, according to a PricewaterhouseCoopers study. Last year, corporate venture funding totaled \$6 billion. This year "we're getting close to the vanishing point," says Kirk Walden, director of venture capital research at PWC.

That's tough news for both startups and corporations with venture funds. The pullout of corporate cash will make it that much harder for new businesses to get off the ground. But it also can hurt

the funders themselves: Many corporate venture-capital units act as adjuncts to companies' research and development departments, helping fill the pipeline of new technology. "We really look to these tech startups to bring us ideas," says Warren Holtsberg, director of venture investing at Motorola Inc. Last year, Motorola pumped \$3.5 million into Centerpost Corp. to get its hands on the Chicago startup's messaging technology. This year,



by
DARNELL LITTLE

Move?

Holtsberg expects to do 40% fewer deals—a potential blow to innovation.

While corporations have been willing to forgo this source of ideas in past tech downturns, the stakes may be higher this time. Given the current pace of technological evolution, “you can get left behind a lot faster now,” says Tim Rohner, a partner at Chicago consultancy DiamondCluster International Inc. who advises companies seeking to set up venture units. Even if it means skimping elsewhere, he says, corporate VCs should try harder to keep their funds active in this downturn than they have in the past.

That’s advice Chevron Corp. is heeding. After investing \$60 million in 2000, Chevron Technology Ventures is having a tougher time unearthing deals for the

\$100 million it has earmarked this year. “Finding new technology to help the business is too important to give up on,” says Don C. Riley, chief of the unit. So far this year, he has invested in two startups with technology that Chevron can use. That’s off the pace he had hoped for, but he says Chevron will keep looking.

As the tempo slows, those still in the dance can be more choosy about their partners. So much money was flying around tech startups over the past two years that investors felt pressured to act fast and skimp on due diligence, says Julian A. Brodsky, vice-chairman of cable TV operator Comcast Corp. “Now, you have time to do the job right,” says Brodsky. So far this year, Comcast has made just two investments. Although he won’t discuss details of either one, Brodsky says both should pay off better than anything he got last year. “The pace is slower, but the quality of the deals is higher,” he says.

Many more companies have closed the spigot on VC investing without completely shutting down their venture units. Autodesk Inc., a software maker based in San Rafael, Calif., has made no new investments in 2001, saying it just wants to

focus on managing its current portfolio. Same goes for the venture arms of software maker Vignette, wireless upstart Aether Systems, and TV giant NBC, although they declined to discuss their reasons.

Few corporate funds have fared worse than Comdisco’s. The market value of Comdisco Ventures’ public holdings plunged from \$683 million on Sept. 30, 2000, to \$5 million on June 30, 2001. Among Comdisco’s losing Internet bets: furniture e-tailer Living.com, which filed for bankruptcy last August; the now-defunct real estate site IProperty.com; and hardware e-store Homewarehouse.com. Comdisco CEO Norman Blake acknowledges that the venture unit suffered from a lack of discipline. “Some basic questions about each investment should have been asked but weren’t,” Blake says. That hit the bottom line: Comdisco Ventures contributed \$110 million in profits in the quarter ended Dec. 31, 2000. By March, that had turned into a \$30 million black hole.

The slowdown in funding is sure to hobble cash-starved startups. But if their erstwhile corporate patrons choke off an important source of innovation, they may suffer as well. ●

CORPORATE SPONSORSHIP

Some Corporate Venture Arms Aren’t Finding the Right Investments...

Corporate venture investors have had a tough time this year. Here are some companies that were active in 2000 but have made no new investments through Sept. 1 of this year.

INVESTMENT FUND	AMOUNT INVESTED IN 2000	COMPANIES INVESTED IN
Liberty Digital	\$65 million in 7 new ventures	Kozmo.com, Food.com, TiVo
Aether Systems	\$112 million in 12 companies	Juniper Financial, AlterEgo Networks
NBC	\$44 million in 9 startups	Petopia.com, SelfCare.com, Space.com
Autodesk Ventures	\$37 million in 7 companies	Epentric, Motiva Software, Capacity Web
Office Depot	\$31 million in 6 investments	Bigstep.com, eFrenzy, NextDoor Networks

Data: Venture Economics, BusinessWeek

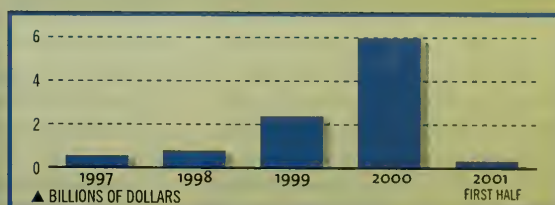
...While Others Are Closing Up Shop or Put Plans On Hold...

CLOSED FUND	
Scient	Comdisco Ventures*
KPMG Consulting	PSINet Ventures*

*Suspended VC activity in 2001 while in bankruptcy

Data: BusinessWeek

...Turning the Flow of Corporate Venture Funds to a Trickle



Data: PricewaterhouseCoopers, VentureOne

Can This Man Cure Drkoop.com?

Turnaround ace Richard Rosenblatt's remedy includes a healthy dose of bricks and mortar

When C. Everett Koop, the former U.S. Surgeon General, first met Richard M. Rosenblatt, the new CEO of struggling Drkoop.com, he took one look at him and asked: "Does your mother know you're out this late?" It was a joke, but the question wasn't totally off-base. Boyish and busting with energy, the 32-year-old Rosenblatt doesn't appear to be a day over 21. During this first meeting with Koop, in an Austin (Tex.) hotel lobby in September, 2000, he seemed awfully cheerful for a guy trying to turn around a company that was on track to lose \$146 million that year on a paltry \$11 million in sales.

In fact, Koop's question wasn't the one Rosenblatt had become accustomed to hearing. "Most people asked me if I'd lost my mind," Rosenblatt says. No wonder. At that time, Drkoop.com was a Web-content business, selling ads and licensing health articles to hospitals. But the Web ad business was slowing, and hospitals were not interested in paying for content. What's more, the company had overspent wildly on everything from an in-house masseuse to \$15,000 worth of fridge goodies each month. Still, Rosenblatt's investment firm, Prime Ventures, ponied up \$6 million of the \$27.5 million raised to save Drkoop from bankruptcy last summer, and he agreed to be CEO.

Why does Rosenblatt think he has the elixir to save DrKoop? He believes the branding power of one of the most recognizable names in health care can sell products. "Dr. Koop is one of our most trusted medical figures," Rosenblatt says. "I think I can turn him into something similar to Martha Stewart or Walt Disney—but for health."

His turnaround plan is as bold as it is unorthodox. While thousands of bricks-and-mortar companies are moving online, Rosenblatt is heading in the opposite direction. After laying off most of the Web site staff and moving the company from Austin to Santa Monica, Calif., he has set out to transform the company into an offline provider of home health care and nutrition products. In August, he bought Ivonyx Group Services Inc., a small provider of in-home intravenous therapy. Late this year, he'll launch a line of nutritional supplements to be sold primarily in drugstores. The Web site will still offer health information, but its key role is to provide sales and marketing for the offline businesses. That's why he changed the company's name to DrKoop LifeCare in August.

Even with the most famous doctor in America on his side, Rosenblatt will struggle to get his company off the critical list. He faces fierce competition from larger players, including Apria Healthcare Group in home infusion and Pharmavite Corp. in supplements. And Rosenblatt has no money to promote DrKoop's new products. He's hoping he can whip the company

into shape and persuade a health or consumer-products company to acquire it before his one-year supply of cash runs out. "They can't do this on their own," says Gartner Inc. analyst Michael Davis. "They just don't have the capital."

With these odds against him, it's a good thing Rosenblatt is a quick study. As a grade-schooler in Woodland Hills, Calif., he became so skilled at cerebral board games like chess that his college professor mother and nuclear physicist father were afraid to play with him. "He had this amazing ability to see the next move," recalls his mother, Jane. A natural-born dealmaker, Rosenblatt spent hours trading baseball cards with his classmates. He carried his collection to school in a locked blue case. "The best card I got was from Hank Aaron's rookie year," he recalls, beaming.

After graduating from the University of Southern California Law School in 1994, he lasted only six months at a prominent Los Angeles law firm. "Sitting at a des-



Rosenblatt in Santa Monica: He needs a miracle

Richard Marc Rosenblatt

Born: Apr. 6, 1969 in Woodland Hills, Calif.

Education: BA in Political Science, University of California at Los Angeles, 1991; JD, University of Southern California, 1994.

Early jobs: Movie-ticket taker, pizza delivery boy, door-to-door knife salesman, fitness instructor. Made his first million while still at law school, mostly through R&R Advertising, a company he started to sell ads for local papers.

Career: In 1994, he started iMall, which provided software tools for small businesses to set up shop on the Net. Sold it to Excite in 1999 for \$565 million in stock, of which he got 10%. Immediately launched Prime Ventures, an investment company that funds struggling dot-coms. He and his partners bought a stake in Drkoop.com, and, last summer he became the CEO.

Koop on Rosenblatt: "He's extremely youthful, with poise and a lot of exuberance. He's a quick study who has made an effort to learn as much as he can about health. I see some of myself in him."

Family: Oldest of two children born to Jane, a professor of biostatistics, and Martin, a nuclear physicist. Didn't think twice about marrying his wife, Lisa, when he was 23 and she was just 21. "When I'm passionate about something, I do it," he says. They have two children, Dillon, 3, and Chase, 1.

isn't for me," he says. The Web was in its infancy then, but Rosenblatt immediately recognized its potential in commerce and launched iMall Inc., which originally sold training seminars to small businesses that were going online. The strategy didn't work. So in 1997—with the stock trading at \$.40 and iMall three weeks from running out of cash—Rosenblatt raised \$20 million and quickly transformed the company into a supplier of Web software tools to help small businesses put up their sites. That clicked, and in 1999 he sold iMall to Excite for \$565 million in stock.

Immediately after selling out, he launched Prime Ventures, a \$17 million fund for ailing dot-coms, and scored some impressive wins. One example: He sold GreatDomains, a reseller of domain names, to VeriSign Inc. for \$100 million—10 times Prime's original investment.

In today's hostile market, keeping DrKoop afloat may be his toughest job yet. iVonyx posted revenues of \$28.5 mil-

lion last year, but it barely managed to turn a profit of \$1.1 million. To increase iVonyx' 1% stake of the \$4 billion market, Rosenblatt hopes to bulk up its salesforce and use the Koop name to grab attention from bigger players. But analysts bet he'll come up short. "This is a business that relies on local connections," says Michael D. Turcotte, managing partner of Results LLC, a health-care consulting firm. "Will physicians refer patients to iVonyx because of Dr. Koop's name? I doubt it."

The Koop brand has better prospects in the supplements business. The \$16.8 billion industry has been rocked by safety concerns, resulting from widely publicized deaths related to ephedra and other herbs. Dr. Koop's name on the four supplements, including Dr. Koop Women's Menopause Health Formula, could carry weight on pharmacy shelves.

Yet, even there, skeptics say the Koop name won't be enough. "The name will

get their foot in the door," says Brent Bailey, president of rival Pharmavite, the maker of Nature's Resource supplements. "But they need to continue to generate awareness to get repeat purchases." And the Web site won't be much help for selling the products. Its traffic, now 500,000 a month, has fallen 70% in the last year, says Jupiter Media Metrix Inc.

Koop himself is confident Rosenblatt is up for the challenge. "I know he's committed to keeping this company on the highest road, and he's on his way to making us a brick-and-mortar health-care leader," Koop says.

With cash running low and doubters all around, the good doctor's encouragement is about all Rosenblatt can count on. •

e.biz online

For a Q&A with former Surgeon General Koop, visit ebiz.businessweek.com

Tesco Bets Small

"But oh, ho, ho, who's got the last laugh now?"

— IRA GERSHWIN, 1936

John Browett, CEO of British online grocer Tesco.com, isn't smug enough to amble around the company's headquarters singing the old Gershwin tune. But few would begrudge him if he did. Assailed by analysts during the peak of the dot-com boom for its go-slow approach to selling groceries over the Internet, Britain's No. 1 supermarket chain has watched one rival after another put up the white flag. Now, Tesco.com has assumed the mantle of the world's largest and most successful online grocer. "We've been a bit lucky," says Browett, "but we've also been right."

Tesco's big bet was to bet small. In 1996, when the Web was exploding and online gro-

ceries seemed like a brilliant idea, Tesco PLC dipped its toe ever-so-gently into the water, outfitting a single store in Osterley, England, to accept orders by phone, fax, and a crude Web site. The idea was to test whether customers would buy groceries without shopping in conventional supermarkets. Equally important, Tesco had to figure out whether it made more sense to pick those groceries off the shelves of its stores or build separate warehouses to fill online orders. By March, 1998, the company had proved there was sufficient demand and that picking from stores worked. But it had to keep tweaking the process to get the economics right. It wasn't until September, 1999, that it rolled service out to 100 stores.

Now, Tesco.com is firing on all cylinders. It has expanded to 250 outlets—more than a third of the chain's 690 British stores—enabling it to



by

ANDY REINHARDT

—and Wins Big

Britain's top supermarket chain was slammed for its go-slow approach to selling goods over the Net. Now it's the world's largest online grocer

deliver to 91% of Britain's population. The business is on track to turn in revenues this year of more than \$450 million and boasts a respectable net operating margin from groceries of around 5%, or more than \$22 million, analysts estimate. Last year, the dot-com unit lost \$13 million due to the cost of expanding into new businesses such as CDs and videos, but it was profitable on groceries. "They were the only company in the world to really get it," says retail analyst David V. McCarthy of Schroder Salomon Smith Barney.

What Tesco got was that selling groceries over the Net was going to be small potatoes for the foreseeable future. After all, the chain is expected to book sales this year of \$30 billion, making its online operation a mere 1.5% of revenues. So instead of spending a fortune to build distribution warehouses outfitted with fancy technology, Tesco chose a decidedly low-tech approach. Fewer than two dozen employees are needed to pull products off the shelves in each store and schlep them in vans to customers in the neighborhood. It's kind of like an electronic version of the

1950s delivery boy. Today, Tesco.com handles more than 3.7 million orders per year—and half of its online customers weren't previous Tesco patrons. Now, the company is building on that foundation to expand into other businesses, such as baby products and wine by the case. "We've got a chance to become the leading 'last mile' delivery service in Britain, because we're taking it very incrementally," Browett says.

"Out on a limb." That's a lesson that failed dot-coms likely wish they had learned. Many Net startups were undone by focusing so much energy on growth that they never knew whether their business models worked until they hit the wall. Says Browett, who at 37 could easily be mistaken for the head of a Web upstart: "You can't make a run for revenues and then work out the cost structure later." Despite that timeless logic, e-commerce gurus from McKinsey & Co. and Andersen Consulting (now Accenture Ltd.) questioned Tesco in 1999 for not building warehouses, prompting the company to recheck its math to make sure it

Web
smart



wasn't heading down the wrong path. "We were clearly out on a limb when the hype was at its peak," Browett says.

Staying the course proved even sweeter for Tesco after the ignominious failure of Webvan Group Inc. The Foster City (Calif.) startup, one of the most richly funded in history, went bankrupt in July. It burned through \$1.2 billion in two years trying to establish a purely Web-based grocer in the U.S. Webvan's strategy was vintage dot-com: It shot for the moon, aiming to build two dozen automated warehouses around the country, costing up to \$35 million apiece, that were supposed to cut 40% off the labor expense of handling groceries. Each was meant to serve a 60-mile radius encompassing millions of potential customers. But after building only three warehouses—in Oakland, Calif., Atlanta, and Chicago—the numbers got worse and worse.

Webvan's Waterloo: Customer demand wasn't high enough to operate the facilities at anywhere near their capacity, so fixed costs swamped revenues. "The first 10,000 customers were easy to find—San Franciscans sitting on the edge of their couches waiting for Web groceries," says analyst Ken Cassar of Internet researcher Jupiter Media Metrix

Inc. "But the rest of the country isn't the same." He and other analysts figure Webvan lost \$5 to \$30 on an operating basis for every order it delivered. When you crank in depreciation, marketing, and other overhead, the loss jumps to a staggering \$132 per order.

Growing competition. By contrast, Tesco's decision to pick groceries out of existing supermarkets kept startup costs low. The company spent just \$58 million over four years to launch its online grocery operation, and has since laid out \$29 million more to expand into nonfood items. The wisdom of that tortoise-vs.-hare approach has been validated by a host of other companies. "Now that the high-cost wacko Internet business model turns out to have been a disaster, Tesco's store-based picking is the direction everybody's going," says analyst Andrew P. Wolf of BB&T Capital Markets in Richmond, Va.

The prime example: In June, Safeway Inc., the No. 3 supermarket chain in the U.S., said that it would partner with Tesco to deliver groceries to online customers. The British chain is investing \$22 million for a 35% stake in GroceryWorks, a money-losing Net startup half owned by Safeway. The companies already have shuttered

three GroceryWorks warehouses in Texas. They plan to begin rolling out the Tesco.com system this fall or early next year in a handful of Safeway's 1,500 U.S. stores. "We liked Tesco's track record," says Safeway spokeswoman Debra Lambert. "They understand how to combine technology with bricks and mortar."

That's not to say there aren't drawbacks to Tesco's approach. Orders are automatically routed from a data-processing facility in Dundee, Scotland, to the nearest store, so customers are limited to buying only what's available there. If it happens to be one of Tesco's smaller outlets, they may have only 20,000 items to choose from, vs. 40,000 at larger stores. Analysts worry, too, that the Tesco.com model won't "scale up" when the business gets bigger. Although its fixed costs are low, Tesco.com has relatively high variable costs because more orders require more labor for picking and delivery. As a result, Tesco.com won't likely be able to reap the economies of scale that Webvan expected from its warehouses—meaning it may never become much more profitable than it is today.

On top of that, Tesco will face growing competition. Despite Browett's claim that the secret of Tesco's success lies in painstaking

Easy Does It

Why is Britain's Tesco.com thriving in the online grocery business when Webvan failed in the U.S.? A comparison of the two companies' strategies and operations reveals crucial differences.

A Boost from Bricks

Tesco: Britain's No. 1 grocer picks and packs its online orders from existing supermarkets, then delivers in nearby neighborhoods using only a few trucks per store. By leveraging its brand, suppliers, and database of 10 million affinity-card holders, Tesco launched online shopping for just \$56 million.

Webvan: Startup Webvan spent \$1.2 billion to build its business from scratch, including \$35 million automated food warehouses. With no existing customers or suppliers, costs soared. A lack of experience hurt, too: None of Webvan board members came from the grocery industry.



One Step at a Time

Tesco: The British giant spent years developing and fine-tuning its online order and delivery systems. After launching with just one store in 1996, Tesco gradually rolled out online service to about one-third of its 690 British outlets today. That puts it within a half-hour of 91% of the British population.

Webvan: Webvan tried to run before it could walk. It aimed to enter 24 U.S. markets within three years, and opened warehouses in the San Francisco Bay area, Atlanta, and Chicago in its first 15 months. Even though none of the warehouses broke even, Webvan kept building facilities in New Jersey and Maryland that never opened.



ingly tested and refined processes, some analysts think competitors can fairly easily copy or improve upon them. For instance, archrival J Sainsbury PLC, the *grande dame* of British supermarkets, is belatedly rolling out delivery service at 36 of its stores but will also operate warehouses near London and Manchester. "We think picking centers are the way to go in the long run," says Sainsbury spokesman Matt Samuel, "but we're using stores to get to market faster."

None of this worries Browett. He thinks Tesco.com can hit \$4.35 billion in

stocked goods by the palette, limiting each warehouse to about 15,000 products.

What really riles Browett, though, is the notion that rivals will have an easy time catching up. "This looks simple on the surface, but the detail underlying it has turned out to be very, very hard," he says. That's where Tesco's by-the-numbers management has proven to be an invaluable asset. Founded in the 1920s by immigrant businessman Jack Cohen, for decades the company played scrappy second fiddle to Sainsbury's. The turning

Britain, period," Hyman says. In recent years, it has expanded into Central Europe and Asia, where it now gets 12.5% of sales, and has opened catalog and financial-services units.

But the dot-com operation may be Tesco's most unlikely triumph. Launched as a skunkworks project with six mid-level managers reporting directly to Leahy, Tesco.com got off to an inauspicious start. For two-and-a-half years—an eternity in Internet time—the unit's managers tinkered with the formula. "We went down some blind alleys and back," admits Tesco.com Chief Operating Officer Carolyn Bradley. After rejecting phone and fax orders as too expensive and error-prone, Tesco settled three years ago on a system that lets customers place orders only over the Web. But the process of picking products off the shelf was punishingly inefficient. In the supermarket business, where margins are thinner than a slice of prosciutto, a few pennies per item can make the difference between profit and loss. And the one thing Tesco wasn't willing to do, Bradley says, was to lose money on its dot-com operation.

When the company retrenched in 1998, it came up with a nifty solution. Rather than having pickers traverse the entire store filling orders for individual customers, each supermarket is divided into six zones—groceries, produce, bakery, chilled

Tesco doesn't build big warehouses; it holds down costs by delivering goods from existing stores

sales—about 10 times today's levels—before running out of headroom in its stores. The biggest concern: Aisles could get clogged with pickers, interfering with everyday shoppers. But long before reaching that point, Browett says, Tesco.com likely will embrace a hybrid approach, using warehouses in dense regions and store-picking for rural customers. As for selection, he says, even Tesco's smallest markets can offer more items than Webvan's warehouses did because human pickers can grab a single jar of capers or saté sauce from a shelf, while Webvan

point came seven years ago, when Tesco marketing execs won an internal power struggle with the traditionally dominant purchasing managers. That resulted in the elevation of then-marketing head Terry Leahy to his current role as CEO of Tesco PLC. From that point, says Richard Hyman, a principal at British retail consultancy Verdict Research Ltd., Tesco has obsessively focused on satisfying customer demand. By the late 1990s, it surged past Sainsbury's in sales and market share, despite its less upscale image. "We think Tesco is the best retailer in

No Free Lunch

Tesco: E-commerce gurus thought grocery buyers wouldn't pay for delivery. Tesco bucked the trend and charged £5 (\$7.25) per order. The chain now gets more than 70,000 online orders weekly and collects \$27 million per year for deliveries alone—the difference between profit and loss. Plus, the fee encourages customers to place larger orders.



Webvan: Newcomer Webvan wooed customers with free delivery for orders over \$50, adding millions in unrecovered costs. Analysts figure that Webvan lost from \$5 to \$30 on every order it handled.

The Web's Not Everything

Tesco: Tesco.com doesn't have to prove itself as a stand-alone business to be a win for the grocer. The online operation helps extend the brand: Tesco.com says that half its customers come from rivals' stores. Those customers, Tesco hopes, will start shopping at its supermarkets.



Webvan: The startup had to survive on its Web sales alone. Yet the dot-com meltdown is proving that the Net is less an end than a means. Customers had no connection to Webvan except through their PCs, so the online grocer couldn't profit from a quick stop-in for milk, coffee, or junk food.

foods, frozen foods, and “secure” products such as liquor and cigarettes. Each picker, outfitted with a rolling cart, scours a single zone retrieving products for six customers at a time. To save valuable seconds and improve accuracy, each item is scanned at the moment it’s picked. Then, customer shipments are assembled in the back room and stacked in vans for delivery. Tesco.com typically fills two to three waves of orders per day, which allows customers to buy as late as noon and receive a delivery by 10 that night.

It’s not just the process but also judicious use of technology that lets Tesco.com keep expenses to a minimum. Each picking cart, for instance, is topped with a wireless touch-pad computer that plans the optimal route through the store and tells pickers what to grab, one item at a time. That lets them average just 30 seconds per item, so a typical order of 64 items can be filled in 32 minutes, at a cost of about

\$8.50, including labor and depreciation, say analysts. Despite Tesco’s efficiencies, that’s still pretty steep—some 7% of the average \$123 order.

The company makes up the difference in several ways. First, it saves about 3% of the order value by not using checkout clerks, Jupiter figures. The real saving grace

margins tend to be higher,” concedes Marketing Vice-President Tim Mason, though the company wouldn’t provide figures or comment on analyst estimates.

There’s another surprising factor that has spelled the difference between success and failure for Tesco. When the company rolled out Web shopping, it bucked

Charging for Net delivery proved to be a masterstroke. Tesco gets about \$27 million a year from the fees

is that online orders tend to have higher gross margins—more than 30%, vs. Tesco’s typical 25%, Schroder Salomon Smith Barney analysis shows. That’s because online shoppers are more affluent and buy more profitable products, such as organic vegetables, quality meats, and private-label packaged goods. “Our success is dependent on the fact that Tesco.com’s

conventional wisdom and imposed a £1 (\$7.25) delivery fee per order, an amount it figured the market could bear. By contrast, Webvan offered free delivery for orders over \$50, which ended up costing it millions in unrecovered expenses. Tesco.com insists customers are willing to pay for service—and the quadrupling of its orders over the past year seems to bear that out. Customer Krista Levey, 27, an executive assistant at Arthur Andersen who buys from Tesco.com about once a month, says the fee “is nothing” compared to the convenience of not having to lug home cases of bottled water on the London Underground.

Charging for delivery proved to be a masterstroke. First, it largely covers the cost of the vans and drivers who blanket the country. Tesco.com takes in about \$27 million per year from the fees, close to the estimated \$34 million cost of deliveries, figures Booz, Allen & Hamilton Inc. analyst Timothy Laseter. Imposing the fee also boosts the likelihood that customers will be at home during the two-hour window for their deliveries, since they have to pay again for redelivery. That’s a big win for Tesco, given that returning merchandise to the store and restocking it could savage margins.

Even more important, the delivery fee has helped raise the typical order size because customers want to get their money’s worth. So the average purchase from Tesco.com is three times a typical \$35 supermarket transaction, a vital contributor to the online operation’s solid gross margin. Eliminating the fee in an effort to stoke demand “would take away the incentive to spend up,” says Schroder’s McCarthy. And indeed, Tesco.com has no interest in boosting sales if the result is a loss on operation

COO Bradley recalls a few blind alleys





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Truth be told, Tesco.com also enjoys advantages Webvan never could have recreated even with another \$1 billion in funding. By being a part of the Tesco empire, it can piggyback on the parent company's advertising, branding, and customer database. As one of the best-known and most trusted names in Britain, Tesco confers instant legitimacy on its dot-com unit. Plus, the online operation gets free ads in Tesco's quarterly mailing to its 10 million affinity-card holders and has linked its Web site to store databases so customers can easily reorder products they've previously purchased online or in a supermarket. On top of that, having pickers in Tesco stores provides constant publicity for the Web service—a benefit Webvan could never enjoy because it had no retail presence.

Tangible and intangible advantages such as these have prompted some analysts to question whether Tesco.com would turn a profit if it were a stand-alone business. ABN Amro's Mark Wasilewski, for one, thinks the parent may not be charging its dot-com unit enough in-store



Tesco.com is now in one-third of Tesco's stores, enabling it to reach 91% of all Brits

costs—depreciation, utilities, marketing, and so on—as a way of making Tesco.com's books look better. Browett dismisses the charge. "There's no point in fooling yourself," he says. Every unit, whether Tesco's financial-services arm or its dot-com operation, has to carry its own weight, he insists. Besides, he adds, the criticism entirely misses the point:

Tesco isn't trying to create a stand-alone business. Tesco.com is merely an additional sales channel that lets the company boost revenues and push more products through its system. As long as it's not leaking red ink, it's a net gain.

So what's next for Tesco.com? Analysts are confident it will keep expanding its business in Britain. By 2004, predicts Wasilewski, it will hit \$2.2 billion in revenues—still just 7.5% of Tesco's total—and generate net profits of \$181 million. Tesco also has announced the first international expansion of its dot-com business, other than the Safeway deal: By the first quarter of 2002, it aims to launch online shopping in South Korea, where it operates seven supermarkets, with 11 more on the way. Tesco chose South Korea because it has the highest residential penetration of broadband Net connections in the world, offering fertile opportunity for online shopping. Meanwhile, at home, Tesco.com is rolling out new services such as its baby center and wine club. These offer not just commerce but also chat areas and simple content—information about, say, infant development or top French vintages. With innovations such as these, Browett may soon start singing the old Gershwin song out loud. •

e.biz online

For a Q&A with Tesco.com CEO Browett, and a look at Australia's online grocers, visit ebiz.businessweek.com

Tesco's Advantage By The Numbers

The secrets to Tesco.com's success are higher margins on groceries, a delivery fee, and lower packing and delivery costs than Webvan.

	TESCO.COM	% OF SALE	TESCO STORE	% OF SALE	WEBVAN	% OF SALE
AVERAGE SALE	\$123.25	100%	\$34.80	100%	\$114.00	100%
MINUS:						
COST OF GROCERIES	\$85.66	70%	\$26.10	75%	\$83.00	73%
CASHIERS IN STORE	—	—	\$.87	3%	—	—
OTHER STORE COSTS	\$15.16	12%	\$4.28	12%	—	—
MARKETING AND ADMIN.	\$5.67	5%	\$1.60	5%	\$133.04	117%
PICKING AND DELIVERY	\$17.80	14%	—	—	\$30.00	26%
PLUS:						
DELIVERY FEE	\$7.25	6%	—	—	—	—
NET PROFIT (LOSS)*	\$6.21	5%	\$1.95	6%	(\$132.04)	NM
*Including delivery fee, before taxes						

Data: BusinessWeek, ABN AMRO, Schroder Salomon Smith Barney, Booz, Allen & Hamilton, Jupiter MMXI, company reports

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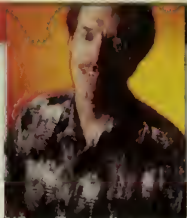
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BY ROBERT D. HOF

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Don't Cut Back Now

Bricks-and-mortar retailers are finding that online visits boost in-store sales

When I asked Target Corp. Vice-Chairman Gerald L. Storch a few months ago whether the retail chain's online site would turn a profit at some point, he assured me it would—that is, if you include the benefits from branding, driving buyers to stores, and cementing closer relationships with customers. Uh-huh, I thought. Sounds even fuzzier than the

dot-coms' much-maligned "pro forma" profits. So I wasn't too surprised when Target announced in mid-September that it's farming out some of its Web operations to Amazon.com Inc.—a move that suggested Target was throwing in the towel online.

Quite the contrary. Target not only will retain its own site, run partly by Amazon, but it will get massive exposure on Amazon's site, which up to 50 million people a month visit. Storch expects the heightened online visibility to boost all those seemingly intangible benefits. I think he's right. According to market researcher Jupiter Media Metrix Inc., only about a third of retailers venturing online look beyond sales and profits on the site itself to determine whether their online efforts are truly profitable. That's a big mistake: They need to understand that their customers use their sites for far more than online purchases.

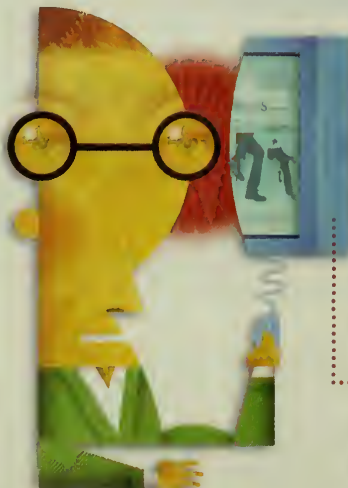
Of course, pure-play Web retailers such as Amazon must ultimately earn a profit, since they sell only online. But it's an entirely different story for the traditional retailers that are starting to assert their dominance on the Net. Demanding fast profits from their Web sites is precisely the wrong thing for them to do. Indeed, Jupiter analyst Ken Cassar estimates that some two-thirds of the return on investment on an online site comes from branding and physical-store purchases. If all they measure is online sales and profits, he says, "there's a real risk that brick-and-mortar retailers may substantially scale back their online investments, which could put them at a big competitive disadvantage."

What might they miss? A recent Jupiter report found that half of consumers use a retailer's Web site for research before buying a product in its physical store. Savvy retailers don't fret about site visitors failing to click on the "buy" button. Instead, they go with the flow by encouraging shoppers to research online and pick up or buy the item in the store. Surveys by Sears, Roebuck & Co., for instance, reveal that some \$500 million worth of in-store appliance sales were influenced by customers researching online first. So what if they don't buy a washer online? Although

Dennis Honan, vice-president and general manager for Sears Customer Direct, says the site will be profitable next year—that's not Sears' only criterion for investing in it.

The results of promoting the brand and strengthening ties with customers are quite difficult to measure. But that's precisely what some retailers, such as Target, see as the main value of their Web sites. Storch says the biggest benefit of Target's online efforts is deepening relationships with its customers—which he thinks will bring them back, both online and to the stores. "Can we prove sales in the store? No," he says. "But is the Web site valuable? Sure."

Justifying continued or even increased spending online is a challenge these days because it's tough to track people accurately across multiple channels. Besides, says Bill Bass, senior vice-president for e-commerce at Lands' End Inc., "at the end of the day profits are what's most important for everybody." True enough. But the companies that don't consider the less obvious benefits of their online efforts will lose customers to rivals that do. ♦





GOD BLESS AMERICA

CA joins the rest of the world in mourning the needless loss of many lives that occurred on September 11. Our sympathies, hopes and prayers are with the families of those who have experienced the loss of a loved one. And those brave souls that have been involved in the rescue and recovery efforts. United, we will prevail.



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Developments to Watch

Y OTIS PORT

NEW SOFTWARE AIMS TO CUT TERRORISTS' CASH

WINNING THE WAR ON terrorism will involve more than military actions. As Secretary of State Colin L. Powell noted, the challenge for the civilized world will be going after, and dealing with, the sources of support that they have." Some of their financing comes from money laundered illegally in the U.S.—part of an estimated \$600 billion in laundered funds that pass through American banks every year. HNC Software wants to stem that tide. The San Diego company has developed a new variation of Falcon, its artificial intelligence (AI) program for spotting credit-card fraud. Falcon is now used by 80% of the top credit-card issuing banks— and has slashed fraud rates by more than half. But the new technology had to be even smarter, says Walter Lee, vice-president of risk management. "With credit cards, you almost always know for sure when fraud has occurred," he explains, "and the software can study each incident to determine the crook's modus operandi and work out patterns to watch for. But with money laundering, some warning-sign patterns can't be nailed down "because some people never get caught."

Lee says the new program uses several AI techniques to monitor bank transactions, looking for such clues as "lots of lots of small deposits, or lots of small international transfers from unusual places, like Caribbean banks." Another red flag: cash deposits with numerous \$100 bills from laundromats, delis, or other small businesses where big bills are normally rare. When the software gets suspicious, it calls in the bank's sleuths.

A 'STRIP SEARCH' THAT'S RATED G

BY YEAREND, RESEARCHERS AT THE NATIONAL INSTITUTE of Standards & Technology's Boulder (Colo.) operation expect to have the first prototype of a system that can scan the passengers in an airport departure lounge and spot concealed weapons. The radarlike system uses low-power, 95-gigahertz waves to see through clothes. It generates images showing plastic and metal objects in people's pockets or taped to their bodies—without revealing too much physiological detail.

THE FAA
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The research is funded in part by the Federal Aviation Administration, which hopes this system will avoid the controversy that enveloped a similar technology. In the mid-1990s, American Science & Engineering in Billerica, Mass., introduced BodyScan. It produces a sort of X-rated X-ray image (photo). While BodyScan's virtual strip search outraged privacy stalwarts, Ralph S. Sheridan, CEO of AS&E, was confident that airline travelers would be willing to sacrifice some modesty for greater safety. But the prudish FAA never gave air passengers an opportunity to decide: Not one of the \$140,000 systems was deployed.

Starting last year, however, the U.S. Customs Service began installing the devices at international airports—at least seven so far.

Suspected smugglers are given a choice of a manual "pat-down," or getting scanned by AS&E's machine operated by a same-sex Customs official. Soon, the NIST device may offer a third alternative.

MODELING A BOMBING AT YOUR BUILDING

WHEN TERRORISTS ATTACKED New York and Washington, Rudolph V. Matalucci was showing managers of government buildings a new risk-assessment program called Rampart. Developed in the wake of the Oklahoma City bombing by Matalucci's team at Sandia National Laboratories, Rampart gauges how well buildings would withstand disasters. Its first version is tailored for the Gen-

eral Services Administration, but Matalucci says Rampart can also be adapted for evaluating commercial buildings, schools, and telecom sites.

Rampart comes with a database of threats and a so-called expert system for determining how particular assaults will affect a building. The threat equations model the destructive force of various-strength tornadoes, hurricanes, earthquakes—and bombs. Rampart spits out rankings that show how vulnerable the building is to each. To mitigate problems that turn up, Sandia has sev-

INNOVATIONS

■ Casualties at the World Trade Center would have been lower if the buildings had held up longer. They might have, with a new concrete being developed by Neven Krstulovic-Opara, an engineer at North Carolina State University. Mats woven from recycled stainless-steel fibers reinforce the surface, so large chunks don't break off when a building suffers an earthquake or bomb blast. The mats can also replace conventional wooden forms. And the labor savings from eliminating wood forms can more than offset the cost of the mats.

■ At Singapore's Nanyang Technological University, researchers are developing an artificial-intelligence system to alert security guards when video cameras pick up suspicious behavior. So far, the system's neural-network software can detect people running or making rapid, violent gestures, says computer scientist Maylor K. Leung. Training the system to spot people who have fainted should be easy, Leung says, but getting it to distinguish between airline workers and terrorists sneaking around cargo areas may be tough.

ods adapted from those used to assure the safety of nuclear-weapons stockpiles.



MATALUCCI: Measuring disaster-readiness

TERRORISM

THE NEXT PHASE: BIOTERRORISM?

Easily produced, germ weapons could wreak even greater chaos than suicide pilots in hijacked planes

As devastating as the World Trade Center and Pentagon attacks have been, a different kind of terrorist strike could be worse—much worse. Try to picture tens of thousands, or millions, of Americans dead; commerce, even the routine delivery of food, paralyzed across the nation; and neighbor set against neighbor as society's institutions crumble.

That's the scenario that could play out if terrorists were to unleash a biological weapon such as smallpox, anthrax, or other devastating agents of disease (table). And currently there's little we can do to prevent it—or contain it once such an epidemic begins. Oklahoma Governor Frank Keating grasped this chilling reality in late June when he participated in a war-game exercise. "It not only stunned me how horrific a biological attack could be," he says, "but also how woefully unprepared we are."

To be sure, some security experts have considered a biological attack to be extremely unlikely. They figure most terrorists don't have the capability to grow and deliver deadly viruses or bacteria. Besides, anyone who unleashes a plague is guaranteed to provoke unprecedented moral outrage and retaliation. And even terrorists know that biological assaults are notoriously unpredictable. Disease epidemics could sweep the planet, indiscriminately killing terrorists' families along with Christians, Muslims, Jews, and everyone else.

But most experts fear that the threat is real and growing. "Bioterrorism will be the next event," predicts Dr. Bertram S. Brown, co-founder of the Potomac Institute for Policy Studies. Intelligence agencies were stunned in 1993 when a defector from the Soviet bioweapons program revealed that the Soviet Union had made tons of smallpox virus for delivery in missiles, in violation of the 1972 Biological Weapons Convention. Another nasty shock came in 1995, when Saddam Hussein's son-in-law defected with news of Iraq's unexpectedly sophisticated bioweapons program.

GROWING CLUB. Now, there's evidence that Iraq, Iran, Libya, China, North Korea, Russia, Israel, Pakistan, and Taiwan have biological arsenals, and the group is growing. Only one or two of these nations is presumed to possess the most dangerous of the scourges, smallpox. But verifying that is difficult—which highlights another dimension of the problem. The facilities for breeding bioweapons, from small factories down to a laboratory bench, are almost impossible to pinpoint or track. Without more defectors, "the amount of hard information as to who has what is minimal," says Dr. D.A. Henderson, director of the Johns Hopkins University's Center for Civilian Biodefense Studies and leader of the successful global effort to eradicate smallpox.

Indeed, because of modern biotechnology, brewing up a pot of deadly germs is easier than ever. "The same fermenter used to make beer or a drug can grow anthrax an hour later," says a Capitol Hill national security aide. In addition, gene-splicing makes it theoretically possible to engineer super-



TOKYO, 1995

The cult that released sarin in subways had plans to use anthrax

germs deadlier than anything nature has created. Even if terrorists can make the stuff themselves, they might buy it from Saddam Hussein or hire a few of the tens of thousands of former Soviet bioweapons scientists cast adrift when the country's facilities shut down. According to some reports, Osama bin Laden has been trying to create a biological arsenal. And Sept. 11 proved that hate and extremism have swept aside political and moral restraints that once discouraged terrorists from mass slaughter. "Today, we talk about flying bombs," says Yonah Alexander, director of the Potomac Institute's International Center for Terrorism Studies. "Tomorrow, we will talk about scientific bombs."

War games have helped the U.S.

DEADLY GERMS

Terrorists could sow unprecedented devastation by unleashing biological agents. Here are some of the most dangerous:

SMALLPOX

A highly contagious virus that would kill about one-third of those infected. Can be prevented only with vaccine given before or within four days of exposure. Vaccine stocks in the U.S. are currently inadequate. Virus was mass-produced in the former Soviet Union.

ANTHRAX

This bacterial disease is not contagious; spores can kill virtually all of those who inhale them unless antibiotics are administered immediately. Known to have been obtained by Iraq and others, including Japanese cult Aum Shinrikyo.



KUWAIT, 1998

An American soldier is inoculated against anthrax

IRAQ, 1988

Saddam Hussein may have used Kurds as guinea pigs to test chemical and biological weapons



Security experts and politicians flesh out the gory details. In June, Colonel Randall J. Larsen, director of the nonpartisan Institute for Homeland Security, conducted a simulation with Johns Hopkins, the Center for Strategic & International Studies, the Oklahoma State National Memorial Institute for the Prevention of Terrorism, Governor Keating, and others. In this exercise, dubbed Dark Winter, Iraqi-financed Afghan terrorists spray smallpox virus into shopping malls in Oklahoma City, Atlanta, and Philadelphia. The attack goes unnoticed until nine days to two weeks later when people start showing up in emergency rooms in Oklahoma City complaining of fever and rash. Trying to contain and fight the outbreak, Keating shuts the state's air-

ports, closes the borders, and orders vaccinations for all medical personnel. The actions anger federal authorities and the military, who want to save limited vaccine supplies for the armed forces. But it's too late, anyway. By then, each victim has infected at least 10 others, some of whom are already spreading contagion in other states.

As the horror spreads, everything spins out of control. Commerce comes to a halt; even food deliveries stop. Nationwide air travel and the stock market shut down. With no treatment, the only way to fight the disease is with vaccines, which quickly run out or can't be delivered, and quarantines, which can't be enforced without heavy-handed military muscle. "All of a sudden, the house of cards falls down,"

says Larsen. Within three weeks, 16,000 people are sick, and more than 5,000 of them will die. After two months, 3 million are stricken, and 1 million will die. And still, the epidemic continues to grow.

As the Dark Winter participants learned, preparations for biowarfare are frighteningly inadequate. The U.S. has only a fraction of the vaccine needed to respond to a smallpox attack. In 1972, a single case of smallpox in Yugoslavia touched off an outbreak that required 20 million vaccinations and mass quarantines to stamp out the disease. The U.S., in contrast, has only 15 million doses of old vaccine, made before 1982. "If we don't prepare for such an awful event, we may put our very democracy at risk," warns Joseph R. Biden Jr. (D-

BUBONIC PLAGUE

Though less contagious than the smallpox plague bacteria could be aerosolized and sprayed by terrorists, then victims spread the disease to others. Nearly fatal without antibiotics.

HEMORRHAGIC FEVERS

Caused by deadly viruses like Ebola with no standard treatment. Spread only by blood or secretions, so less contagious than other agents. But has high potential for inducing terror. Aum Shinrikyo members went to Zaire to collect samples.

GENE-SPLICED WEAPONS

New viruses or bacteria could be engineered in the lab to be far more virulent than today's disease agents. Fortunately, creating such "Franken-germs" is still difficult.

Del.), chairman of the Senate Committee on Foreign Relations.

Of the myriad biothreats, smallpox presents the gravest danger because it's so contagious and because the general population in the U.S. hasn't been vaccinated since 1972. Health authorities decided then that the risks of vaccination were greater than the danger posed by a disease being wiped out globally. But in a twist of history, we could be victims of the same scourge that Europeans—sometimes intentionally—unleashed in the New World centuries ago, decimating Native American populations.

There are plenty of other threats, as well. A suspected accidental release of just milligrams' worth of anthrax from a Soviet facility in Sverdlovsk in 1979 killed more than 65 people. Iraq has admitted

to producing vast amounts of anthrax. And after the Japanese cult Aum Shin-rikyo killed people on the Tokyo subway with a nerve gas in 1995, authorities learned that the group had been planning a more deadly attack using large quantities of the bacterium. Without prior vaccination or quick administration of antibiotics, anthrax is almost always fatal. "If terrorists went Johnny Appleseed and distributed it here and there across the country, there would be chaos," says Hopkins' Henderson.

NATIONAL STOCKPILE. The sliver of good news is that the U.S. has begun to face this potential horror. In 1999, the Clinton Administration launched a bioterrorism initiative. Among other things, the effort has beefed up laboratories' ability to quickly identify suspected bi-

ological agents and created a national stockpile of antibiotics and drugs that can be rushed to fight a nascent epidemic. Also, in September, 2000, the government signed a \$343 million contract with biotech company Acambis PLC to make 40 million doses of smallpox vaccine by a new production method. "It will be packaged in new kits, ready to go," says Thomas Monath, MD, Acambis vice-president of research & medical affairs.

Meanwhile, states have set up offices to handle the complex coordination among hospitals, rescue teams, law enforcement, and others needed to fight a terrorist bioweapons attack. "We have ways to go, but we're better prepared now than we've been before," says Julie A. Casani, medical coordinator for

THE NUCLEAR NIGHTMARE JUST GOT MORE REAL

Most people now know that a jetliner can be a weapon. What they might not realize is that it can also serve as a nuke. Think what would have transpired if the terrorists who targeted New York's World Trade Center had chosen to ram one, or all, of the hijacked jets into a nuclear power plant. "There wouldn't be the explosion of a nuclear bomb, but you would still have the release of radioactive contamination that would produce major fallout," says Edwin S. Lyman, scientific director of the Nuclear Control Institute in Washington. In other words, another Chernobyl.

National security experts have been warning for years that the U.S. is vulnerable to a terrorist attack using "weapons of mass destruction" such as biological agents or nuclear bombs. The federal government tended to downplay those warnings. But not anymore. After the Sept. 11 attacks, the U.S. put on standby alert its Nuclear Emergency Search Team, which is trained to respond to terrorists armed with nuclear weapons. V. Alan Mode, a former division leader of the counterterrorism effort at Lawrence Livermore National Labs, says other modes of aggression, including bioterrorism, are a far likelier threat, but "the effects of a nuclear attack are so massive that you must give it a tremendous amount of respect and thought."

Other experts are on the same page. Testifying before the Senate Foreign Relations Committee last March, former



TEMPTING Other towers, other targets: Sept. 11 changes the nature of nuclear threats

Senate Majority Leader Howard H. Baker Jr., co-chair of an Energy Dept. task force on nuclear security, declared that "the most urgent unmet national security threat to the United States today is the danger that weapons of mass destruction or weapons-usable material in Russia could be stolen and sold to terrorists or hostile nation states."

MISSILES UNLIKELY. Certainly, it would be a challenge for terrorists to come up with a nuclear capability, including the missiles needed to deliver a conventional nuke. Only in Hollywood does the

idea of stealing nuclear warheads find any credence. And security experts who fret about future borne suicide attacks acknowledge that blowing up one of America's heavily reinforced nuclear power plants would be far from easy. (They are designed to withstand plane crashes, but so was the World Trade Center.)

The more urgent immediate threat is that terrorists might get their hands on small arms weapons-grade uranium, plutonium and build a crude but still devastating bomb. Some 603 of these materials are scattered across the former Soviet Union, under security conditions that have raised

alarms around the world. Several years ago, the U.S. committed \$2.2 billion helping Russia protect those materials. But the U.S. General Accounting Office reported last February that only 10 percent of the supplies have been fully secured and the Bush Administration recently cut the budget for the program.

The production of homemade nuclear weapons is more than a hypothetical problem. The International Atomic Energy Agency reports that illicit trafficking in nuclear materials has doubled since 1990 and counts 370 confirmed cases of smuggling.

emergency preparedness and response for the state of Maryland.

Not only will such plans lessen the toll from bioterrorist attacks, their existence "will discourage the use of the organisms in the first place," Henderson believes. After all, if the U.S. is capable of nipping epidemics in the bud, why bother even launching a bio attack? Here's another benefit: Boosting public-health capabilities will improve America's ability to respond to nature's own outbreaks, such as West Nile virus or tomorrow's equivalent of AIDS. But experts warn that current preparations are just a start. Unless the U.S. and the rest of the world step up efforts to combat bioterrorism, the toll next time may be so high that even the horror of Sept. 11 will pale in comparison.

By John Carey, with Phoebe Eliopoulos in Washington and Neil Gross in New York

past eight years. A State Dept. notes that as many as 130 terrorist worldwide have expressed interest in obtaining nuclear capabilities—among them Osama bin Laden's Al-Qaida. "Many Russian nuclear sites remain vulnerable to insiders determined to steal existing material to make several weapons," states a report issued by the U.S. State Dept.'s researchers. "The Task Force advised that buyers from Iraq, Iran, and other countries have actively sought weapons-usable material from nuclear sites."

REASONABLE CHANCE. They wouldn't buy all that much, either. "If you took a softball-size lump of enriched uranium materials [mostly] available in the Soviet Union, and an engineering grad from an American university, you would have a reasonable chance of making" a nuclear weapon, says Graham T. Allison, director of the Belfer Center for International Affairs at Harvard University and an expert on nuclear terrorism. The resulting bomb could level a large portion of lower Manhattan, he warns. "The most frightening is that terrorists are not constrained by the same concerns that keep nations with nuclear weapons from pushing the button. If such weapons were used to pursue political or religious goals, the deployers would not fear losing public support for their agenda. Members of extremist cults are not subject to such constraints, argue terrorism experts. One only need look at the hijacking of the World Trade Center on Sept. 11 and consider how much worse it could have been if the same fanatics had loaded the plane with radioactive material on board." —Catherine Arnst in New York, with Neil Gross in Boston

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A CALL TO ARMS AWAKENS DEFENSE

But the size and shape of the buildup remains unclear

At first blush, the Sept. 11 attacks on the World Trade Center and the Pentagon seemed to have transformed the prospects for defense contractors. Prior to those suicide missions, Congress was aiming to hold defense spending to a modest 5% increase next year. Procurement was basically flat. No surprise, then, that expectations for the sector were lackluster at best. Says Robert Torray, manager of the \$1.7-billion Torray Fund, which owns big stakes in General Dynamics Corp. and Raytheon Co.: "Before this began, I didn't think [defense stocks] were going up at all."

When the markets reopened for trading on Sept. 17, however, the defense sector defied the overall plunge. Average gains for defense contractors ranged from 15% to 20% on the first day of trading and remained high in the following days. Raytheon, which makes Tomahawk cruise missiles, set the tone: Its stock surged by 25%. The largest defense contractor, Lockheed Martin Corp., climbed by 15%. And L-3 Communications Holdings, a defense technology company, was the day's overall leader—with a 38%

ON LAND...

The Fox tank from General Dynamics

gain. About the only big defense contractor that fared poorly on the first day of trading was Boeing Co.

Shares at the nation's No. 2 defense contractor fell 18% on fears that commercial jet sales, which still account for nearly 60% of Boeing's revenues, will plummet.

Boeing aside, many investors figured that with all the saber rattling in Washington, military spending was bound to grow. Indeed, the most aggressive analysts conjecture that the 2001 defense budget of \$302 billion will balloon 30% or more by 2003. And about one-third of every defense dollar flows to the defense contractors in the form of procurement, research, or development. "Everything we thought we knew about the budget a week ago is meaningless now," says Loren B. Thompson, an analyst for the Lexington Institute, a defense-industry think tank.

LOOSER PURSE STRINGS. Increased military spending is assured. But even with the Congressional purse strings loosened, it's unclear how much that will boost industry revenues. That will depend on what type of war is ultimately conducted and how long the operations last. These questions—which can't be answered right now—have caused other analysts to be skeptical about the sector's prospects. Even some of the contractors are unsure that Congress' new willingness to spend will be central either to helping antiterrorist efforts or their own businesses. Says James Fetig, director for corporate relations for Lockheed Martin and a retired U.S. Army

officer: "We think it's premature to speculate how recent events will

affect the defense industry. Investors should not expect a windfall."

One way to get a handle on how the sector will do is to look at past military engagements, such as the Persian Gulf War in 1990. The invasion of Kuwait sent the general market skidding 15%, while defense stocks climbed 17%. Yet a few months later, after U.S. tanks started to roll, markets rebounded sharply. That signaled the start of the 1990s bull market—and the defense companies were ultimately left out. The war ended, and defense spending fell, which prompted massive consolidation within the industry. Boeing gobbled McDonnell-Douglas Corp. and Rockwell

A BOOST FROM THE SABER RATTLING

NORTHROP GRUMMAN

It was already outperforming other contractors with its strategy of buying up electronics programs such as Grumman's Joint STARS ground surveillance plane. Even more of that equipment will be needed now.





erospace. Northrop
lapped up Grumman
erospace and then com-
bined with Litton Indus-
tries. Lockheed Corp and
Martin Marietta Corp.
Both swallowed other companies, then
merged into the largest defense con-
tractor of all.

Defense-industry gains were short-
lived, too, following the Kosovo crisis
in 1999. After that engagement began,
defense stocks rose 5% to 10% but then
tumbled after three months, largely be-
cause it was clear that U.S. involve-
ment would be on a relatively small
scale. "If this is a sustained conflict,

...AT SEA...

The Tomahawk
missile, made by
Raytheon

Raytheon

Coalition is likely to
more of its Tomahawk
missiles. Its radar
systems are found aboard
F-15, and F/A-18
jets, the B-2 stealth
bomber, the F-117 stealth
fighter and the U-2.

GENERAL DYNAMICS

A leader in high-tech gear
to fight biological and
chemical warfare and the
contractor for the new
Advanced Amphibious
Assault Vehicle, a \$4 billion
program to carry the Marines
ashore.



Alliant Techsystems is the
country's biggest producer
of bullets and solid-
propellant rocket motors
for the armed forces. In
times of conflict, these
"consumable" products
are in high demand.



... IN THE AIR

The Hellfire, launched
from helicopters, uses
ATK's rocket motors

we're looking at a strong
growth market," says
Richard Aboulafia, an analyst
at the Teal Group in Reston,
Va. "But if the Taliban turn
over [Osama] bin Laden in
the coming weeks, then it's a
Kosovo effect."

BULLETS AND BOMBS. If it's a
drawn-out affair, conventional
investor wisdom is that some
military contractors will prosper.
The favored companies are
those that make military
electronic and surveillance
gear and "consumable" prod-
ucts—the trade's lingo for
bullets and bombs. Northrop
Grumman Corp., for exam-
ple, is big on information
technology and also makes

the Global Hawk unmanned recon-
naissance plane. Another long-standing
favorite, General Dynamics, makes Aegis
destroyers, encryption tools, tactical-
communication systems, and countermea-
sures against chemical and biological
weapons. A new favorite, Raytheon, pro-
duces surveillance and reconnaissance
radar, and laser detection and night-
vision systems. Some smaller players in-
clude Alliant Techsystems Inc., the

largest supplier of ammunition to the
U.S. military, and L-3 Communications,
which makes defense electronics, flight
data recorders, and bomb-detection gear.

A limited Afghan engagement, mean-
while, would probably use a combina-
tion of special-forces operations and air
power. Certainly that could drive up de-
mand for additional spare military parts,
bullets, smart bombs, and various cruise
missiles. But in general, antiterrorist ac-
tions are more "manpower-intensive than
equipment-intensive, and most of the
planned emergency antiterrorist funds
will not be directed toward equipment
procurement," says Christopher Mccray,
analyst for Deutsche Bank Alex. Brown.

On balance, defense spending in-
creases need to be fairly broad for most
of the primary defense contractors to
show significant earnings growth. "Talk
of World War III is grossly overblown,"
adds Byron Callan, a veteran Merrill
Lynch & Co. aerospace analyst. "We're
not going to be in an arms race." The
U.S. military is not into "attrition war-
fare but into precision strikes," adds
George Mueller, president of Boeing's
Phantom Works research center and a
retired U.S. Air Force lieutenant gen-
eral. The biggest immediate change is
that the U.S. is not going to allow ter-
rorism to fester as it has in the past.
But "it's not obvious that this is a prob-
lem that can be fixed by throwing money
at it," Mueller says.

Nevertheless, support for much high-
er defense spending will likely carry
the day. Even if funding for the
controversial National Missile
Defense System seems assured,
critics such as Teal Group's
Aboulafia say the Star Wars pro-
grams is about as relevant as
France's Maginot Line. "But po-
litically it could prove to be very
popular," he says. "People are
looking for anything to protect
the heartland."

*By Stanley Holmes in Seattle,
with Geoffrey Smith in Boston*

NORTHROP: A TOP GUN IN THE DEFENSE BUILDUP

When the stock markets reopened on Sept. 17, Northrop Grumman Corp. turned in one of the best performances among the companies in the Standard & Poor's 500-stock index, rising nearly 16%, to \$94. Sure, all of the defense stocks have rallied in the wake of the Sept. 11 terrorist attacks, but defense analysts say Northrop is among the best-positioned to capitalize on the uptick in Pentagon spending that may be in the making. "The most immediate hardware demand that this crisis will generate is for intelligence gathering and command and control," says Loren B. Thompson Jr., an analyst at the Lexington Institute, a think tank in Alexandria, Va. "Those are Northrop's strengths."

Such was not always the case. When Kent Kresa rose to CEO of Northrop in 1990, the company was in abysmal shape, rocked by cost overruns and charges of fraud. With half its revenue coming from the controversial—and short-lived—B-2 stealth bomber program, Northrop was widely considered takeover bait. Kresa got the company out of its tailspin with a high-tech buying spree, acquiring the electronics, information-technology, and small-scale-weapons companies whose products are suited to post-cold-war conflicts. "We looked where the future was going," Kresa says. "It was surveillance, information technology, and precision strikes. We didn't want to be Liquid Paper when word processors came along."

NET SAFETY. Northrop is a big supplier of radar and other components for the U.S. Air Force's forthcoming F-22 Raptor fighter and the existing carrier-based F/A-18E/F planes. Its info-tech unit protects Pentagon computers from Internet attacks. Analysts expect revenues of that \$3.5 billion unit to climb 25% a year through 2005. Northrop



KRESA'S BATTLE PLAN

Under CEO Kent Kresa, Northrop has outperformed other defense contractors. Still, he faces challenges:

WIN NEWPORT NEWS Kresa has to convince defense and antitrust officials that his bid for the shipbuilder tops that of General Dynamics. Wall Street analysts wonder why he's bothering.

BOOST EARNINGS Kresa must deliver on Northrop's \$5.1 billion acquisition in April of Litton Industries. He said it would boost 2001 profits at least 10%, but so far it has only dragged them down.

BUILD NEW BUSINESSES Northrop and the Pentagon may face an uphill fight getting Congress to fund such expensive programs as the Joint Strike Fighter, the Navy's DD-21 destroyer, and the proposed Strategic Defense Initiative.

also hopes to benefit from projects still in development, such as the U.S. Navy's DD-21 destroyer, the multi-force Joint Strike Fighter, and the unmanned Global Hawk reconnaissance plane. "That could be very valuable for gathering intelligence in places like Afghanistan," says Andrew F. Krepinevich, director of the Center for Strategic & Budgetary Assessments, a defense think tank.

Kresa's first big acquisition was Grumman Aerospace in 1994. With that came the U.S. Army contract for the Joint Stars air-to-ground surveillance planes. In 1996, he picked

up Westinghouse's defense-electronics business, which included advanced radar systems. And in 1997, Northrop landed Logicon Inc., which designs and runs government computer systems. This April, Northrop added Litton Industries Inc., prized for its defense electronics and info-tech unit. With Litton came two sizable but troubled shipyards. Kresa says he can whip those into shape. JSA Research Inc., which provides analysis on the defense industry, says Northrop sales should double this year, to \$13.5 billion, and grow about 22% a year through 2005, while earnings, up 28% to \$608 million last year, should climb 12%.

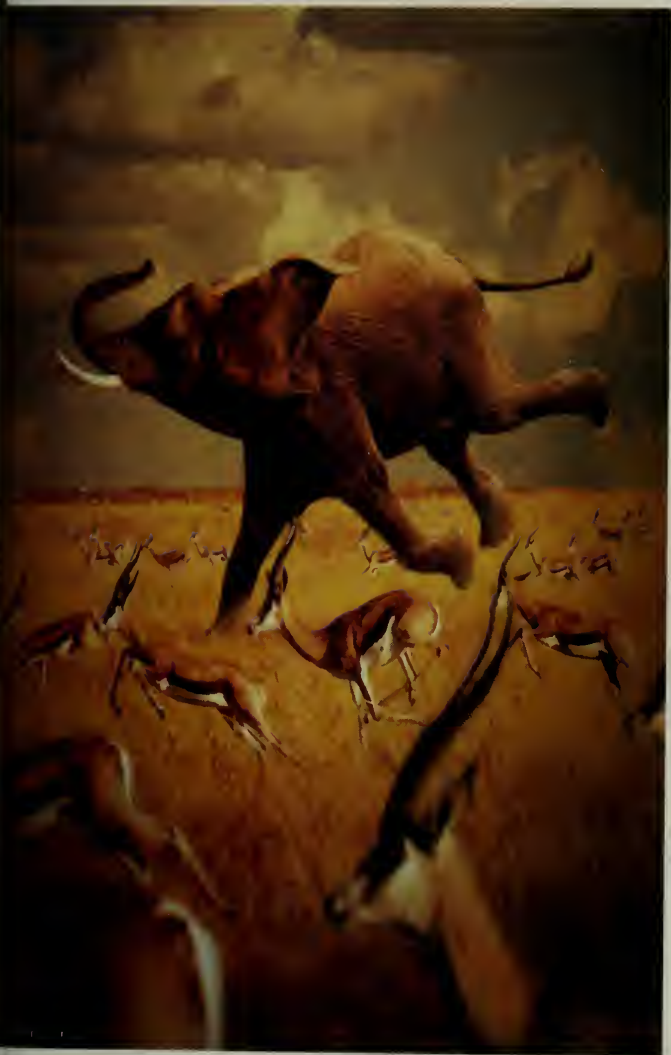
Kresa is still looking to buy. In the past five months, he has been battling to win Newport News Shipbuilding Inc. Kresa has tried to convince the Pentagon and the Justice Dept. that a rival bid from General Dynamics, which would combine the only two U.S. nuclear submarine makers, would be costly and anti-competitive. He claims a Northrop takeover could save \$2 billion over a decade. And it would let him bolster Litton's ship operations. So far, General Dynamics has the inside track,

say analysts. But Wall Street has speculated that the Pentagon won't allow any merger, preferring separate suppliers if the terrorist attacks prompt a slew of new orders. The Pentagon says only that its review is proceeding.

Kresa is understandably reluctant to boast about Northrop's prospects these days. That those prospects are so strong, however, is recognition that the strategy he laid down a decade ago is paying off.

By Christopher Palmeri in Los Angeles, with Stan Crock in Washington

STURDINESS MEETS HUSTLE



With companies that supply electricity, broadband capacity and natural gas to one of the nation's highest population growth regions, we are able to maneuver wisely in any situation. For instance, when the energy market shifts, our diverse fuel mix enables us to respond by producing energy in the most cost-efficient manner. And our aggressive trading of energy on the open market gives us yet another way to enhance our bottom line. So, although we're structured for stability, when it comes to the future, we have no intention of standing still.



Progress Energy

HOW UPS DELIVERED THROUGH THE DISASTER

Decisions made before and during the attack helped it cope

At first, Joe Liana thought it was just his cell phone acting up. But United Parcel Services Inc.'s district manager for Manhattan grew suspicious as calls to his wife and his office were greeted with busy signals on the morning of Sept. 11. He had taken a rare day off to play golf in Queens, and as he dialed for the umpteenth time, he saw a boy running up to him on the third hole. The World Trade Center had been attacked, the boy cried. Liana had 27 people working there. He threw down his clubs and raced off the course, calling out to his stunned golf partners: "I'm going to Manhattan if I have to swim."

Liana caught one of the last trains to Manhattan that day, then flagged down the first UPS truck he saw to take him to UPS's vast complex on 43rd Street near the Hudson River. Once there, the burly 30-year UPS veteran had wireless messages sent to every driver's computerized clipboard, telling them to call in.

Within three hours, he learned that his only casualties were four trucks, crushed in the buildings' collapse. Then he summoned all 4,000 of his employees to 43rd Street. With air traffic halted and many streets closed or impassable, they sorted through tens of thousands of packages, looking for medical supplies, then made 200 deliveries to hospitals, doctors, and pharmacies. "I've learned to stay out of the way and let our folks run the system," says UPS Vice-Chairman Michael L. Eskew.

Every shipper, from FedEx Corp. to Emery Worldwide, bounced back quickly. Within days, packages were arriving at homes and offices across the U.S., thanks to smart crisis management and Herculean efforts to solve logistical nightmares. UPS was more fortunate than rival FedEx because it's less reliant on airplanes for deliveries. A series of key decisions at UPS, the world's largest private shipper, helped to



HOLDING AREA

UPS vows to ship the thousands of packages that were destined for Lower Manhattan on Sept. 11

product on any given day. Its ability to cope was the result of decisions made both years ago and in the chaotic first moments of the disaster.

What saved UPS was a combination of corporate culture and technology. Its decentralized system empowers district managers such as Liana to make key decisions. Most disasters, after all, are local. But each district is tied to a worldwide computer network that enables managers to pinpoint the location of each package, whether a box of

semiconductors from Singapore or a truckload of vegetables from California. "That saves us from having to unload 20 trucks to find one little package the way we had to do it five years ago," says Darden. Other shippers have similar systems.

FAST WORK. Still, the disaster tested UPS to the core. Although most of its deliveries are made at night, UPS had one of its 620 planes in the air when the ports were shut down, says Robert Lekites, general manager of the air unit. Planes bound for Anchorage, for example, were diverted to Vancouver, B.C. Packages had to be transferred to trucks. To prevent its ground fleet from choking on the extra volume, Eskew and Darden decided early on to deliver only packages that could reach their destinations within three days, gambles that UPS would be able to fly again on both coasts by the end of the week.

READY FOR THE WORST

Key decisions that saw UPS through the catastrophe

- ▶ Spending billions on a network that allows the company to track packages from pickup to delivery.
- ▶ Empowering local managers to handle crises on their own. That's given them experience in keeping up deliveries through snowstorms and earthquakes.
- ▶ On the day of the disaster, holding back from the ground system an air package that would have taken more than three days to deliver.



That hunch proved correct, though UPS had to beg and borrow equipment to get airborne again.

UPS is up and running again, but challenges remain. It takes drivers 16 hours to run the gauntlet of new security checks at the Pentagon. Two codes in lower Manhattan were obliterated, and five can no longer be reached by UPS trucks. And UPS must figure out where to deliver 25,000 to 40,000 packages destined for the buildings that collapsed; they now sit in tractor-trailers.

They won't sit for long. UPS executives say they're determined to find the appropriate recipient for those packages, if just to prove that no one can thwart its delivery system.

By Charles Haddad in Atlanta

FINDING MARKET SIGNS IN CHARTS IS TOUGH? TRY FINDING THEM IN TEA LEAVES.



You won't see it on Wall Street. But there's a sign that could mean big trouble for American tea companies. It's tea leaf damage. To spot it, you have to be in position to go to the field where it occurs. In Asia. And Scudder is. Because we know events that happen abroad can affect markets here. That's why we've built a global network of analysts and partners. These experts get information firsthand and translate it into smarter investments. Ask your financial advisor how our worldwide perspective can help you. Call Scudder Investments at 1-800-621-1048. Or visit www.scudder.com. You'll start seeing all the market signs. Even those that come in Asian tea leaves.

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IS CLEAR CHANNEL HOGGING THE AIRWAVES?

Its radio, TV, concert, and billboard empire, amassed with little antitrust scrutiny, is drawing howls from rivals

Five years ago, Clear Channel Communications Inc. was barely a blip on the radar screen among the nation's owners of radio stations. Few outside the industry had ever heard of the San Antonio-based broadcaster. But that was before consolidation swept through the industry in the late 1990s. Spurred by deregulation, Clear Channel began to gobble up assets under the leadership of its low-key CEO, rancher L. Lowry Mays. In August, 2000, the company topped off its acquisition spree with the \$23.8 billion purchase of radio-station and billboard giant AMFM Inc. and the \$4 billion buyout of promotions-and-venue behemoth SFX Entertainment Inc., which itself had been on a four-year buying binge.

That one-two punch made Clear Channel the nation's No. 1 radio chain, billboard owner, venue operator, and concert promoter. Today, the company, with \$5.3 billion in annual revenues, has operations in 63 countries, including some 1,200 radio stations, 19 TV stations, 770,000 outdoor ad displays, and 135 live-entertainment venues. The next-largest radio company, Infinity Broadcasting Corp., pales by comparison, with just 183 stations.

QUESTIONS. Now, having amassed its Texas-size empire with relatively little regulatory scrutiny, questions are being raised about the company's leverage and reach. One group in particular is crying foul: regional concert promoters. In recent months, these promoters, who rely on radio airplay and touring to break new acts and strengthen established ones, have been accusing Clear Channel of anticompetitive practices. They say it uses its radio influence to boost its concert business by withholding radio play from artists who aren't booked on Clear Channel tours—thus squeezing small promoters out of business.

The antitrust complaints culminated on Aug. 6, when Nobody In Particular Presents (NIPP), a Denver concert promoter, sued the media giant in federal court. NIPP accuses the company of "monopolistic and predatory practices," including claims that Clear Channel's promotion arm, Clear Channel Entertainment (formerly SFX Entertainment), blocks other concert promoters from properly publicizing their shows on Clear Channel's radio stations. Clear Channel has until Oct. 5 to respond to the lawsuit. "Yes, we're big," CEO Mays told *BusinessWeek*. "But big is not bad."

NIPP's lawsuit represents the first time anyone in the music business has tried to curb Clear Channel's market clout in court. But it may be just the beginning. In July, Representative Robert E. Andrews (D-N.J.) requested an investigation by Attorney General John Ashcroft into whether Clear Channel is engaging in unfair business practices after New Jersey rock-concert promoters complained. Meanwhile, NIPP and other concert promoters, such as Jam Productions Ltd. in Chicago, say

the Justice Dept. contacted them a few months ago regarding Clear Channel. Justice declined to comment, but a source close to the agency says Justice has been "monitoring Clear Channel and SFX for some time."

Clear Channel execs insist the company doesn't stifle competition unfairly. Mays counters that consolidation is good for the industry, creating efficiencies of scale and benefits for consumers. Mays and other Clear Channel brass say that, to their knowledge, there is no Justice Dept. investigation under way. "Our interest is not in squeezing the little guy out," says Mays. "But we want to expand and grow our business the best we can."

MANY TENTACLES. Clear Channel is certainly a powerful presence in some major markets where it is able to use its entire spectrum of businesses to promote local entertainment events. For example, it can give away tickets on its radio stations for a rock concert it's promoting in one of the halls it owns. Meanwhile, those stations can push the band on the air and the company can deploy a bevy of local billboards to trumpet the event. Clear Channel has such overlapping assets about 85 markets (table).

That kind of clout is what bugging competitors. Clear Channel execs respond that the company was pursuing the strategy alleged by its competitors, it would be hurting its own

MARKET CLOUT

The San Antonio broadcaster dominates in radio, concerts, and promotions nationwide*

METRO AREA	RADIO STATIONS	OUTDOOR AD SPACES	ENTERTAINMENT VENUES
LOS ANGELES	8	13,593	3
NEW YORK	5	13,301	6
HOUSTON	8	5,269	2
CHICAGO	5	15,612	4
SAN FRANCISCO	7	6,983	6
PHILADELPHIA	6	4,290	6
DENVER	8	628	1
DALLAS	5	5,593	0
SAN DIEGO	9	829	0
WASHINGTON, D.C.	8	2,482	4

*December, 2000 Data: Clear Channel Communications Inc.



most of its media brethren, the company has been facing a dismal advertising environment since last December. Prior to the terrorist attacks on Sept. 11, its stock, at 43, was down 30% over the previous year, and down from a high of 67 in February. Now, the economic fallout from the attacks will likely include a new blow to ad spending.

Already, during its second quarter, pro forma radio revenues declined 7.1% from the year-ago quarter. For all units of the company, pro forma second-quarter revenues declined 1.5%, to \$2.20 billion, from \$2.23 billion for second-quarter 2000. Meanwhile, the company racked up a second-quarter net loss of \$237 million, vs. net profits of \$31.2 million a year earlier. Clear Channel is now warning that it will report a net loss in the third quarter, too, with



CEO MAYS:
"Big is not bad"

that in August it said it was hiring 500 new account executives for its 8,000-person radio ad-sales team to drum up new accounts. "Clear Channel has been the lightning rod of investor scorn because of decelerating advertising growth," says Hodge.

"When there's a turnaround, they'll be the lightning rod on the way back up."

Meanwhile, among competitors, the outcry is growing about what is seen as Clear Channel's near-monopoly. "Clear Channel uses the leverage of their radio stations to intimidate groups to play [concerts] for them," charges Jerry Michelson, a partner at Chicago's Jam Productions. "We should have a level playing field." John Scher, a director of Metropolitan Entertainment Group, an independent promotions company in New York whose events have included the Woodstock revivals in 1994 and 1999, says Clear Channel has created a difficult environment in which to book shows. "It's an awesome task to compete against a company that controls most of the music radio in a market," he says. "Consolidation has left the industry in a less healthy state."

CRUSHING PRESENCE? In Denver, where Clear Channel owns 628 billboard displays, the 3,600-seat Fillmore Auditorium, and eight radio stations, including all of the area's rock stations, NIPP partner Jesse Morreale charges that "there's way too much potential conflict of interest here." Before Clear Channel's rapid expansion, Morreale says NIPP was putting on some 600 to 800 shows a year. He blames Clear Channel's overwhelming presence in the Denver area for the 14-year-old company's loss of numerous shows and events.

Even so, some analysts are skeptical that Clear Channel's rivals can build a successful antitrust case. "It's clear that their competitors are at a competitive disadvantage," says analyst James M. Marsh of Robertson Stephens. "But the fact that your competitors are crying doesn't make it an antitrust issue." If enough of them start crying louder, though, it just might become one.

By Stephanie Anderson Forest in Dallas, with Tom Lowry in New York

Independent promoters say the giant skews local radio play and ads to artists that are booked on Clear Channel's concert tours—squeezing regional players out

business. Steve Smith, chief operating officer of Clear Channel Entertainment, says it would be counterproductive for Clear Channel to let its concert lineup dictate the playlists of its radio stations. "It could jeopardize ratings in the radio business," says Smith, where profit margins are about 40%. And though the concerts division is Clear Channel's fastest-growing unit, margins there are only about 12% "on a very, very good year," he says. So to jeopardize the radio business for the concert business "would be like tripping over dollars to pick up pennies," says Smith.

And these days, Clear Channel has a keen interest in doing anything to bolster radio revenues, which have been hit hard by a decline in advertising. Like

cash flow falling below expectations.

Despite the gloomy numbers, Wall Street still likes Clear Channel. "They are in strong financial, strategic, and competitive shape," says analyst Paul T. Sweeney of Credit Suisse First Boston. True, the company's earnings before interest, taxes, depreciation and amortization (EBITDA), by which performance at many media companies is measured, fell 13% in the second quarter, to \$615 million, and could decline for the year by 10%, to \$2.2 billion, estimates analyst Gordon Hodge of Thomas Weisel Partners. But because of its acquisitions, Clear Channel's reported revenues will grow by a robust 51% this year, to \$8 billion, predicts Hodge. Even so, Clear Channel is so skittish about ad revenues

COMMENTARY

By Catherine Yang

MEDIA OWNERSHIP: WHY BIGGER IS A BIG MISTAKE

Suddenly, media companies that have lived for years under rules restricting their reach see freedom just over the horizon. Regulators and the courts are now considering loosening rules that have limited cross-ownership among newspapers, broadcasters, and cable companies. In this new world, a cable operator would be able to serve over 30% of pay-TV viewers. A broadcaster may be able to beam to over 35% of the nation's viewers. Newspapers could own TV stations in their same markets. Cable companies would even be able to buy broadcasters and vice versa. The result would be an industry swamped by merger mania.

It's not a far-fetched vision. On Sept. 13, the Federal Communications Commission voted to reexamine current caps on cable ownership as well as the ban on newspapers merging with broadcasters in the same market. A week earlier, the D.C. Court of Appeals heard challenges to the cap on national broadcast ownership and the ban on cable-and-broadcasting mergers. The rationale? Some regulators think the rise of new media outlets such as the Web make the limits obsolete. "Nobody can intellectually defend the proposition that the marketplace has not changed dramatically," says FCC Chairman Michael K. Powell.

But regulators still need to ensure the original objective of the old rules: a broad spectrum of viewpoints—made possible, in part, by diverse ownership of the media. If they think the rise of the Net guarantees a multitude of independent voices to counter a fast-consolidating Old Media, they're wrong. The Web is no longer the pristinely entrepreneurial phenomenon many people still like to imagine. Big media, such as AOL Time Warner Inc., already control the content many online users get.



POWELL: Reviewing the FCC's rules

Without these rules, "a handful of Old Media giants become tomorrow's New Media powerhouses," says Jeff Chester, executive director of the Center for Digital Media, which advocates competition in online media.

If the feds are adamant about dismantling existing rules, they should weigh the impact of such a move not just on traditional media markets but on the development of future digital markets. Consider that most of the news people get on the Net comes from existing media giants.

CHOKING OFF COMPETITION

The lifting of ownership caps has led to more media consolidation and fewer viewer sources for news

VIACOM/CBS A few weeks after the FCC, in August, 1999, lifted its ban on a single company owning two TV stations in a local market, Viacom announced it was buying CBS. The merger was completed in May, 2000.

NEWS CORP.'S FOX/CHRIS-CRAFT On July 25, the FCC waived its 35% cap on national broadcast ownership. That allowed Fox Television Stations, only days later, to close its deal to acquire the 10 TV stations held by Chris-Craft Industries.

AOL TIME WARNER AND AT&T BROADBAND In September, No. 2 cable operator AOL Time Warner expressed interest in merging with No. 1 cable operator AT&T Broadband. Combined, the entity would control 39% of the nation's cable systems. That exceeds the 30% national cable ownership limit, but the FCC has hinted that it wants to raise that cap.

The top news Web sites—msnbc.com, cnn.com, nytimes.com, abcnews.com, usatoday.com—command from 3 million to 10 million visitors per month, according to Jupiter Media Metrix. Contrast that with New York-based OnlineTV Inc., one of the few independent sites that provided Webcast footage of the World Trade Center attack rather than TV news clips. OnlineTV, which usually offers entertainment fare, got only 334,000 hits that day, says CEO Rick Siegel. His company is barely making it on the \$4.95 monthly fee its 31,000 registered users pay. Big media companies "will dominate...through their ability to fund," says Siegel. "It's impossible to compete with them."

SAME STUFF. The proverbial low barriers to entry on the Net don't help much. It may cost only \$100 to buy a Webcam to hook up to the Web, vs. big bucks for printing plants or TV gear. But independents typically can't deploy the network of correspondents needed to compete with the biggies. Moreover, financial success in mass media depends on reaching the biggest audience possible, and few little guys have the ready-made audience of say, AOL Time Warner. That merger in January gave familiar Time Warner brands, such as *Time* and CNN, access to AOL's 31 million subscribers—about half of all U.S. Internet users. The result:

"The Internet basically offers the same content as a newsstand or TV set," says Vin Crosbie, president of Digital Deliverance LLC, a media consulting firm in Greenwich, Conn.

The time has passed to think the Web will democratize media. Policymakers need to preserve some limits on corporate ownership to ensure a spectrum of views not only in traditional media but in New Media, too.

Yang covers the FCC from Washington.

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BASKETBALL

BETTING THAT HIS AIRNESS WILL SOAR AGAIN

If a Jordan comeback fizzles, it could cost marketers dearly

Michael Jordan may or may not be the greatest basketball player of all time. But he is unquestionably the most prolific corporate pitchman hoops has ever seen, with about \$45 million a year in endorsement deals. Jordan also is almost 39—and more brittle than the airborne wonder fans remember. During months of clandestine training this summer for a possible comeback, he cracked a rib and was hampered by chronic knee pain.

Therein lies the dilemma for companies trying to figure out the latest chapter of Michael and the NBA: How to make the most of a triumphant return without frittering away millions if Jordan gets hurt or, just as bad, turns out to be an uninspiring imitation of his former Airness.

Even before the World Trade Center and Pentagon attacks really gave pause to advertisers, the possibility of a Jordan return after a three-year layoff was presenting tough choices, say ad execs and sports marketers. "Not that I predict mediocrity for him, but if Jordan were to stubbornly play on as a human Michael as opposed to a superhuman Michael, his advertisers definitely would be hurt," says Robert Williams, president of Burns Sports & Celebrities Inc. in Evanston, Ill., which matches sports stars with endorsement deals.

"Jordan is a wonderful myth who left at the top of his basketball game. If you're a consumer brand, anything that tarnishes that myth can't be good," adds Mark DiMassimo, president of DiMassimo Brand Advertising in New York.

Big names like Gatorade and Nike either won't discuss Jordan's comeback or are guarded about their plans. Champion Athleticwear, which will make the Jordan jerseys that should be on racks

at sneaker stores if the word is go, has also clammed up. Champion does acknowledge that weeks ago it began accepting orders for Washington Wizards' Jordan shirts.

Although he played his last game in 1998, Jordan never disappeared from some ad campaigns. Nike Inc. continues to push its Jordan brand, including



ON PINS AND NEEDLES

Among the companies that have deals with Jordan are:

Nike	MCI
Gatorade	Bijan (cologne)
Hanes	Sportsline.com
Electronic Arts	
Palm	
Oakley	
Rayovac	

MICHAEL:

Almost 39, he faces a higher risk of injury

a hot-selling basketball shoe. Gatorade still uses Jordan, often pairing him in its TV commercials with other elite athletes, including soccer superstar Michael Hamm. His comeback means more face time for the NBA icon but not necessarily new commercials. Companies will be tempted to repackage old Jordan footage for a month or two—or at least until he proves that he still has his game, say sports marketers.

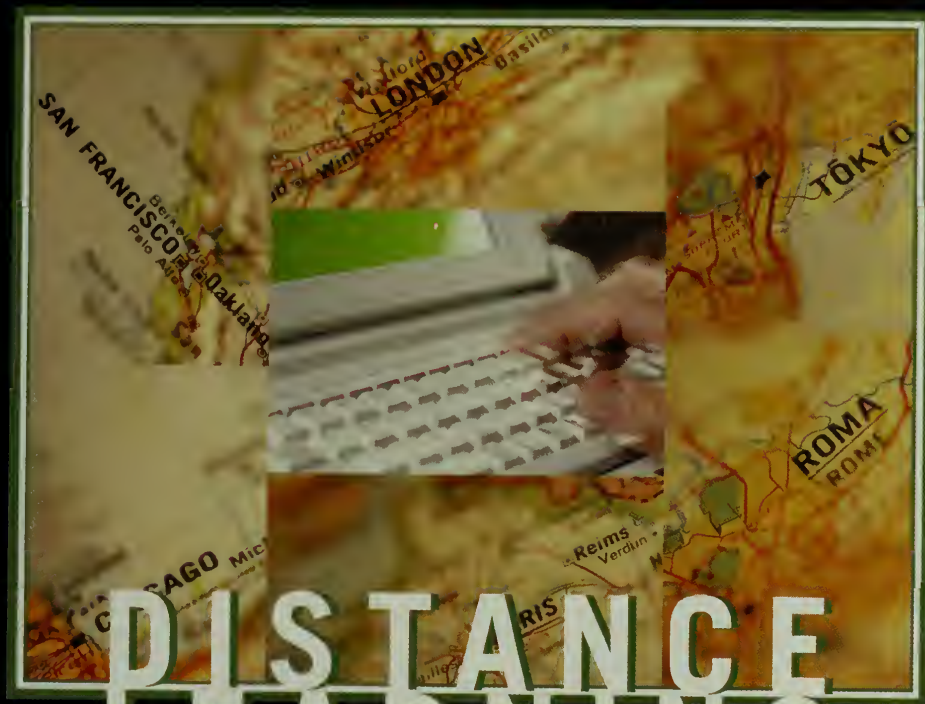
That way, not a lot of money is on the line. But for some companies, the risks involved in a Jordan comeback are as great as the opportunity for killer rewards. Champion, one of two companies licensed by the NBA to produce Jordan jerseys, has had an anxious few months waiting for the basketball legend to make up his mind. The sports apparel manufacturer, based in Winston-Salem, N.C., had reason to be wary. For Jordan's last comeback, Champion ramped up production of a jersey for the Chicago Bulls, his team at the time with the number 45 emblazoned on the back. Not long into the comeback, Jordan switched to the number he had worn during his earlier career, 23, sticking the company with shirts bearing the right name and wrong number.

GUESSING GAME. This time, there have been other challenges for Champion. Jerseys of the woeful Wizards, Jordan's new team, are among the slowest sellers of the 29 NBA franchises. If Jordan decides to pass on a comeback, Champion could be left to sell off the equivalent of three-armed sweaters. Even with Jordan back in uniform, Champion will still be under pressure to guess right about demand: Its deal to produce league jerseys ends in July, meaning it has limited time to sell to the bare walls.

Plus, there's no telling whether Jordan gear will be as hot with NBA fans this time, especially with the youngsters who don't remember Jordan at his high-flying best. "I don't think there's any question that for the first week or two after he comes back, his jersey will be No. 1," says Mark Hoffman of apparel researchers Sport Scan Info.

After that, it's anyone's guess how long the Jordan magic will last. "I don't think teens have been waiting for Michael to come back. Teens want to align themselves with what's hot—someone like [Los Angeles Lakers star] Kobe Bryant," says Peter Land, a former NBA executive who now heads sports marketing at Edelman Public Relations Worldwide. Still, maybe Michael can change their minds—if he doesn't sprain his ankle first.

By Mark Hymowitz



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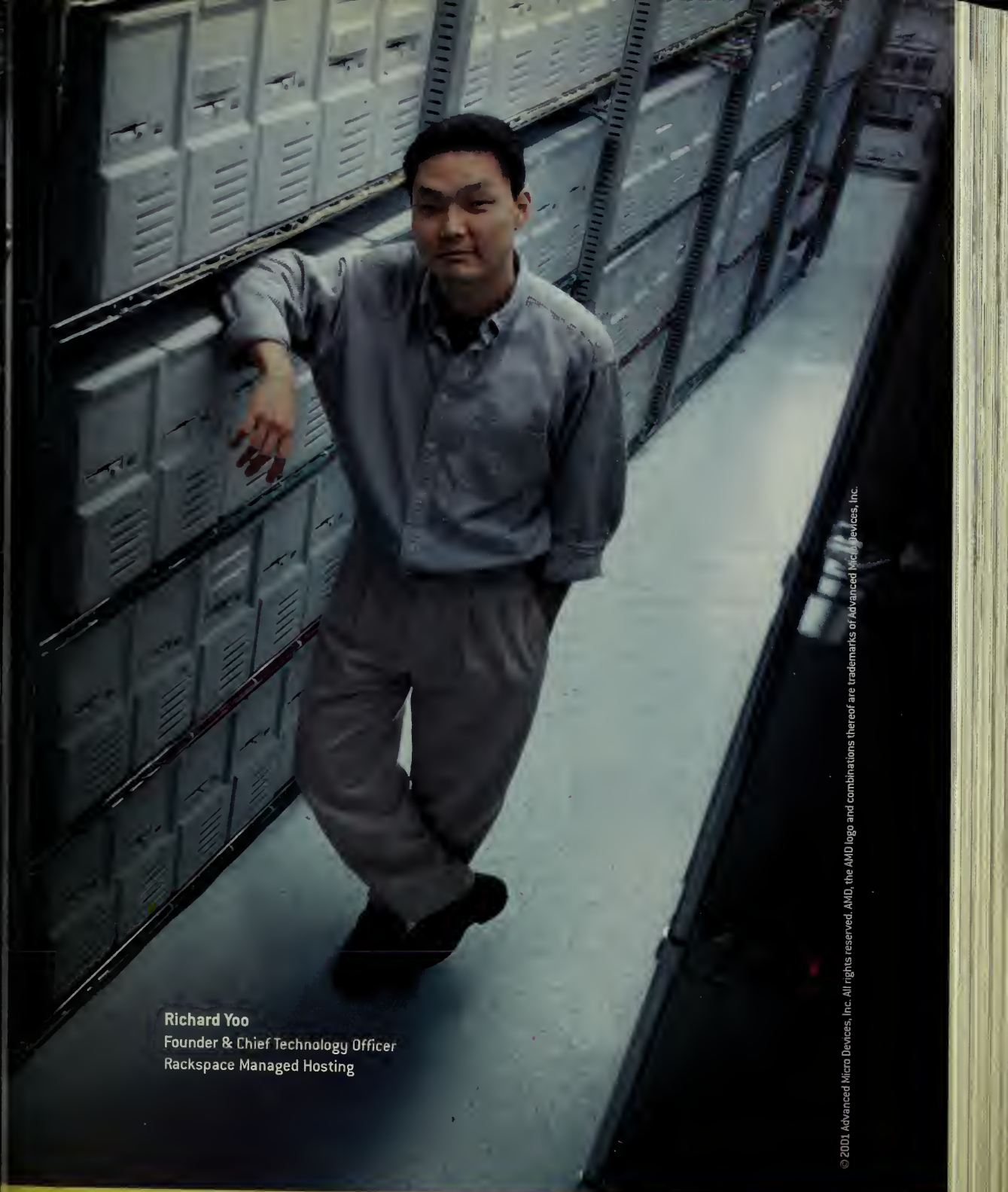




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A photograph of Richard Yoo, a man with dark hair wearing a light blue button-down shirt and grey trousers, standing in a server room. He is leaning against a rack of server units with his right hand. The room is filled with rows of server racks, and the perspective is from a slightly elevated angle looking down at him.

Richard Yoo
Founder & Chief Technology Officer
Rackspace Managed Hosting

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BRUCE DOWNEY, GENERIC DRUG LORD

The CEO of Barr Labs is litigating his way to the big time

Bruce L. Downey has always had a knack for making a buck. As a teenager in the town of Athens, Ohio, Downey would set some 80 steel traps along the Hocking River to catch muskrats. Then he would skin them in his family's garage and sell the pelts for about \$3 each. And after the river overflowed in Athens in the early 1960s, Downey used his father's boat to ferry stranded college students through the flooded streets for a few days. He netted a couple of hundred dollars from that operation. "I was a hustler," Downey recalls with a laugh.

These days, the 53-year-old Downey is after the big money. As chairman and chief executive of the generic drugmaker Barr Laboratories Inc., the onetime trial lawyer has spent millions to challenge patents on some of the big pharmaceuti-

cal companies' most valuable products, racking up a series of impressive wins as well as lucrative—and sometimes controversial—settlements. He's now gearing up to make patented products as well. To big pharmaceutical companies, Downey is a major headache, threatening some of their most important franchises. And while Downey paints himself as a champion of the consumer in his efforts to bring cheaper drugs to market, critics argue his settlements have benefited Barr at the consumer's expense. While other generic drugmakers may use the same strategy, no one has enjoyed Downey's success in recent years. "His record is unsurpassed," says SG Cowen Securities Corp. analyst Ian C. Sanderson.

Downey's most recent victory came after a five-year fight with giant Eli Lilly & Co. to invalidate a critical patent on the \$2.6 billion blockbuster antidepressant Prozac. Under current drug laws, that gave Barr the exclusive right to sell a form of fluoxetine, a generic version of Prozac, for six months beginning on Aug. 2. Such exclusivity is meant to encourage companies to bring cheaper drugs to market. While a flurry of other Prozac generics could hit when that six months is up, Barr will get a nice sales boost in the meantime. For the fiscal year ending in June, 2002, fluoxetine sales should top \$250 million, according to Jon D. Stephenson, an analyst with Barr investor State Street Research.

NO WHINER. No one could succeed as Downey has without being tenacious, even fierce. Having grown up on a 200-acre farm, he still enjoys a good chase, hunting quail once a year with buddy Charles "Chuck" Conaway, CEO of Kmart Corp. As a young lawyer in the 1970s, Downey helped lead some of the Justice Dept.'s cases against certain state testing for teachers, arguing it had a discriminatory effect against African American teachers. When

he first arrived at Barr in 1991 as outside attorney, he had to take on the Food & Drug Administration, which wanted to shut Barr down over what the agency described as serious manufacturing problems, including weak quality-testing procedures. Downey made the unusually aggressive decision to sue the FDA, contending its moves against Barr weren't legal. In the end, Barr largely deferred to the FDA, but Downey kept the company going. In January 1993, he was appointed president and chief operating officer. He became chairman and CEO one year later when founder Edwin A. Cohen stepped down. He has since challenged patents on eight products, taking on many of the big drug companies. Downey claims to relish the contests: "You have to either be prepared to do battle with the people who want to do you in, or whine about. We aren't in the whining category."

Now, Downey is considering a ra-



BRUCE DOWNEY

BORN Nov. 12, 1947, Athens, Ohio.

EDUCATION BS in economics, Miami University, 1969. Law degree, Ohio State University College of Law, 1973.

POSITION Chairman and Chief Executive, Barr Laboratories.

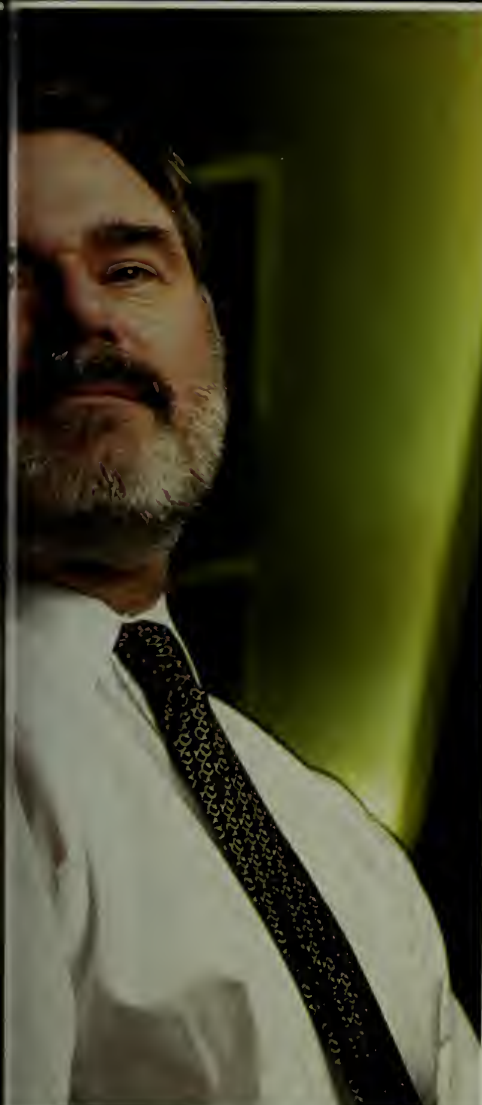
EARLY JOB After a flood in Athens, he and a teenage friend ferried stranded college students in his father's fishing boat.

BEFORE BARR Downey worked as an attorney for the Justice Dept. and the Energy Dept. Then he went into private practice.

ONE DAY Downey hopes to buy the Ohio farmhouse in which he grew up from the current owners. "My wife's terrified I'll buy it," he says.

HOBBY Quail hunting with friend Chuck Conaway, CEO of Kmart.

FAMILY Married to wife, Deborah, since 1984. One son, one daughter.



NEXT TARGET

Downey is gearing up to make his own patented brands

fiscal 2003. Downey argues that profits on tamoxifen may hold steady or even improve since Barr will get

higher margins from manufacturing and selling the product on its own.

Still, with that uncertainty, Downey will use the payoff from fluoxetine to build a branded business. Among his options: licensing or buying compounds that the Lillys and Mercks of the world may pass up. Without a big sales force, though, Barr may not be able to do much with those drugs. And some on Wall Street warn that Downey's proven expertise in the courtroom doesn't assure him success when it comes to identifying promising compounds, conducting complex clinical trials, and crafting an effective marketing strategy. "It's a new playing field where they haven't demonstrated the ability to compete," says Arnhold & S. Bleichroeder analyst Megan Murphy.

Downey is already at work transforming Barr. In June, even before he won the Prozac case, he struck a \$576 million stock deal to buy Duramed Pharmaceuticals,

which has a 125-person sales force specializing in women's health. Downey plans to double that number. He hopes to launch a new oral contraceptive in 2003. If approved by the FDA, the pill, Seasonale, will reduce the number of menstrual cycles women have from about 13 a year to just four. That option may appeal to those who suffer from severe PMS or endometriosis. While the drug is unlikely to snag a big chunk of the \$2.3 billion market, Downey believes it could give a big boost to Barr. Although Seasonale may go up against widely used birth-control pills from companies such as Johnson & Johnson, Dr. Albert G. Thomas, director of family planning services at Mt. Sinai Medical Center in New York City, considers it a viable alternative. But, he says, "the larger the sales force, the more often a drug will be used."

Not surprisingly, Downey is litigating his way in, too. In March, 2000, he struck a settlement with longtime foe DuPont Pharmaceuticals Co. Barr had sued the company in 1998, alleging that it was illegally disparaging Barr's generic version of DuPont's big-selling blood-thinner, Coumadin. Although DuPont did not admit any wrongdoing, it agreed to give \$45 million over four years to help Barr develop three branded products.

RESALE RIGHTS. In fact, Downey's willingness to throw in with his competitors has drawn some unwanted attention. The Justice Dept. has asked for documents related to the tamoxifen settlement. Downey believes the matter is closed. And the Federal Trade Commission has launched a study to determine if drug companies have entered into deals to delay the introduction of cheap generic products. Under a 1997 settlement with Bayer over its antibiotic Cipro, Barr dropped its patent challenge. In return, it got either the right to resell the product or receive payments of nearly \$30 million a year. Bayer, which refuses to comment, has chosen to make the payments. In addition, six months before the Cipro patents expire in 2003, Barr will be able to resell the product, most likely at a discount. Consumer groups have filed lawsuits against Barr and others alleging that the tamoxifen and Cipro settlements keep the prices of those drugs artificially high. Naturally, Downey disagrees. He points to unsuccessful patent challenges against those drugs by other companies and adds: "In both cases we'll launch a lower-cost product prior to patent expiration and save consumers money."

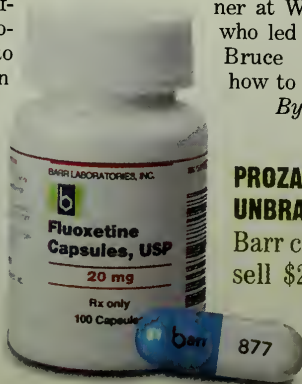
Although Downey doesn't want Barr to have to rely on courtroom victories, he's not backing off from patent fights. In fact, he is challenging patents on two of J&J's birth-control products, which J&J insists are valid. "He has people digging into corners where others might not be looking," says James F. Hurst, the partner at Winston & Strawn who led the Prozac fight. Bruce Downey knows how to sniff out money.

By Amy Barrett in Washington

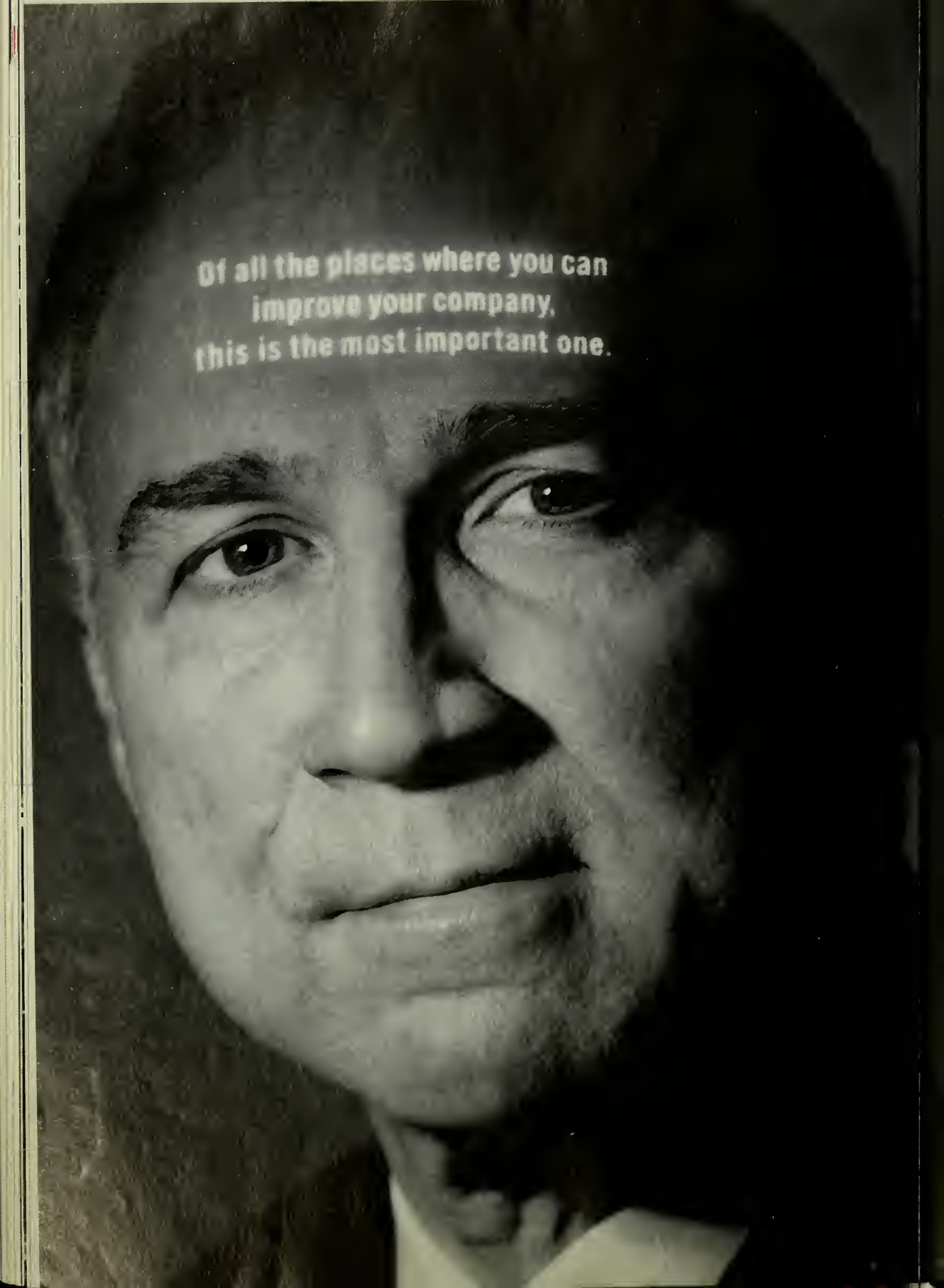
PROZAC UNBRANDED

Barr could sell \$250 million

worth of fluoxetine this year



new strategy. He wants to push aggressively into the market for brand-drugs. With Barr's sales nearing \$1 billion annually, Downey figures it will be enough to generate strong growth if he relies entirely on the intensely competitive and often unpredictable business of selling generic drugs. For several years, Barr has relied heavily on the breast-cancer drug tamoxifen citrate. Thanks to a settlement with Barr struck in 1993, the company receives tamoxifen for AstraZeneca at roughly a 10% discount. An AstraZeneca spokesperson declined to comment on Downey. In the fiscal year ending June, 2001, tamoxifen accounted for 35% of Barr's \$509 million in sales and 48% of its \$62 million in net income. But generic versions of the drug did hit the market as early as 2002. Analysts think that could easily send the drug's sales down to \$200 million—even as low as \$16 million—in



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CHINA

THE ENGINE IS MISFIRING

China was a rare bright spot in the global economy. Not anymore

Tour the factories along China's busy southern coast and nothing at first seems amiss. Companies great and small are still making the dolls, T-shirts, and computer peripherals that have flooded the world and helped fuel China's booming economy. China, in fact, has defied the global slowdown and offered practically the only good economic news on the planet. But talk to the workers and bosses, and you'll get at a more disturbing truth. Orders are less brisk. Prices are falling. Inventories are piling up. Says the manager of a toy factory near Guangzhou: "Everybody here is anxious."

China is slowing down. That was happening even before the terrorist attacks on the U.S. Now, with the global economy experiencing yet more stress, Beijing will be hard-pressed to sustain the growth. That has serious implications for a nation already bracing for a flood of imports and competition as it prepares at long last to join the World Trade Organization.

WEAKER PUNCH. In recent years, the Chinese government has helped keep the economy humming. Since 1998, Beijing has issued \$43 billion in Treasury bonds, pumping the proceeds into public works and higher official salaries. That, in turn, has helped sustain the spending power of the nation's 80 million middle-

class consumers, whose purchase of everything from TVs to automobiles to cell phones accounts for nearly half of gross domestic product.

Now, it appears, Beijing's pump-priming is losing its punch. In recent months, consumer prices had been rising as demand stayed strong, reversing stubborn deflation that had persisted for nearly three years. But last month, the consumer price index rose 1% year-on-year, the lowest growth in five months. "The government is spending lots of money in hopes the external environment will pick up," says Yiping Huang, an economist at Salomon Smith Barney in Hong Kong. "The efficiency of that spending is declining quite quickly."

One key problem is the widening chasm between China's cities and countryside. With more than 800 million rural residents earning barely a third of what their urban counterparts take in, Beijing's efforts to boost consumer demand beyond the cities is not working. While most urban residents have already bought their color TVs, air conditioners, and refrigerators, rural residents, who earn an average of \$270 a year, can't afford such purchases, says



Beijing University economist Song Guoqing. "The gap between rural and urban sectors is growing at an unsustainable speed," he says.

Another drag on consumer spending is the sharp drop in China's stock markets, which are down as much as 10% this year. The selloff is being fueled partly by Beijing's necessary, but confidence-sapping, crackdown on market manipulation. Some 65 million Chinese own stocks, and their decline has created a reverse wealth effect by making people feel poorer. That helps explain why retail sales growth slowed, year-over-year, to 9.6% in August, compared with 10.3% for the first half.

In addition, China's export sector, which equals about 20% of GDP—is facing huge new challenges as the world economy goes into recession. While exports grew a robust 27.8% in 2000, analysts predict they will tread water this year. Take the toy industry. Last year, it exported \$5.6 billion worth of product, more than 60% going to the U.S. In the first half of this year, toy exports from Guangdong province, where most of China's toy factories are located, were almost 20%. "Originally, we expected the bad situation to be reversed in the second half of this year, with all the holidays coming up," says Li Danming, deputy chairman of the Guangdong Toy Association.



OLYMPICS INFRASTRUCTURE:
Costs could reach \$22 billion

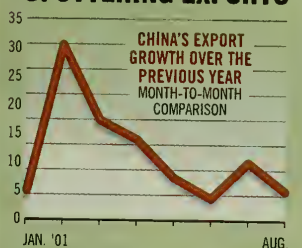


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s go. Last year, Konka sold \$100
on worth of color sets, making it
a's largest TV exporter. But with
al demand steadily declining, the
pany reported a \$23 million loss in
first half, its first ever. Faced with
1 bleaker prospects for overseas
th, Chen Deqing, general manager
Konka's overseas marketing center,
ons exports will increase only “a
bit” this year.

s export markets dry up, glutted in-
ories are expected to get much big-
Indeed, one reason China's TV sector
d abroad in the first place was to es-
a brutal price war at home. Share
s of China's major electronics com-
es have fallen by an average of 20%

SPUTTERING EXPORTS



▲ PERCENT
*THE CHINESE NEW YEAR HOLIDAYS FELL IN JANUARY
THIS YEAR, AFFECTING EXPORTS
Data: State Statistical Bureau, Moftec

wide glut in steel will keep prices low for the foreseeable future. Diversification into other businesses is not always an answer either: MII has started limiting the number of licenses to produce mobile phones, for instance, because most of China's top TV makers have moved into that industry, sparking a price war.

STILL ATTRACTIVE. To be sure, China is in better shape than many of its Asian counterparts. Foreign investment is up 20.39% so far this year. And some believe that the mainland's cheap labor and huge domestic market will still attract investors. At the same time, the Chinese government intends to keep priming the pump. Earlier this month, Beijing pledged to issue an additional

over the last 12 months. Things are so bad that the Ministry of Information Industry (MII) says the industry may collapse.

Falling prices are hurting other industries, too. Many expect the ongoing price war among mainland PC makers to continue until at least yearend. Baoshan Iron & Steel Co. and Angang New Steel Co. say a world-

SHANGHAI BUILDUP: *The domestic inventory glut is expected to get bigger*

\$18 billion in Treasury bonds next year. That money will pay for a 15% rise in civil servant salaries, the third such hike in two years, as well as continued infrastructure spending. And as it prepares to host the 2008 Olympics, Beijing aims to spend \$22 billion in the coming years on stadiums, roads, railways, and sewage treatment plants.

Trouble is, all that spending is putting pressure on government finances. Beijing insists the deficit is running at an acceptable 2.7% of GDP. But that figure rises to 50%, says Beijing University's Song, if one factors in the estimated \$250 billion worth of bad loans held by state-owned banks as well as Beijing's pension liabilities. “If the government keeps up this spending,” says Song, “we’re on the road to danger.”

With the world bracing for a period of uncertainty, boosting domestic demand seems like China's only option. And with rural regions falling further behind the prosperous coastal cities, that is even more crucial. The last thing China needs is the sort of social unrest that could wreck its great free-market experiment.

By Dexter Roberts in Beijing, with Mark L. Clifford in Hong Kong

COMMENTARY

By Brian Bremner

NOW, WILL KOIZUMI BAIL OUT THE BANKS?

In early September, Japanese Financial Services Minister Hakuo Yanagisawa traveled to the U.S. to reassure financiers and politicians that Japan's banking system was recovering. "Of course, if a catastrophe occurs, the story might be different," he acknowledged in a Sept. 4 interview.

One week later, catastrophe occurred. The terrorist attacks in the U.S. sent global markets plunging, setting off a vicious cycle for Japan's banks. Between Sept. 11 and Sept. 17, the Nikkei market index fell 7.6%, to 9,504, a 17-year low, although it closed at 9,679.88 on Sept. 18. Banks' stock portfolios were battered. The dollar's drop against the yen threatens to make Japanese exports pricier. Fewer exports means lower profits and more loan defaults; that pushes more banks to the edge.

The World Trade Center tragedy also shattered confidence. The global financial system can't afford the collapse of the Japanese banking sector now. Japan's officials can no longer maintain the fiction that the \$145 billion in bad loans carried by the money-center banks is manageable. Fortunately, Prime Minister Junichiro Koizumi's government may be coming to terms with the banking fiasco. On the Friday after the attacks, Koizumi sounded resolute about ending Japan's addiction to debt: "Even if low economic growth persists, we will go forward," he said.

WRITE-DOWNS. The hope is that Koizumi's team will take the next step. Until Sept. 11, Yanagisawa's position on the bank crisis was that the banks are in trouble but don't need yet another government bailout. Investors fretted that without the leverage of a government rescue, Koizumi couldn't force massive loan write-downs on the banks. Then, on Sept. 14, Japan's fourth-largest retailer, Mycal Corp., collapsed. Why is

that important? Because its lenders should have forced Mycal into receivership years ago but held back for fear of the hit they would take. Now the banks have pulled the plug on Mycal's \$8.7 billion debt. As a result, Mizuho Bank—created from the three-way tie-up between Dai-

vehicle, deserves more money. Another hint: Ex-Prime Minister Kiichi Miyazawa said he discussed a bank cleanup with Koizumi on Sept. 10.

Investors think this means Koizumi is mustering support for a plan to inject massive funds into the banks, probably via the RCC, using the economic fallout from the World Trade Center disaster as political cover. "It would be a silver lining if the Japanese government were to seize these circumstances to justify a new round of capital injections," says HSBC Holdings PLC Chief Economist Peter Morgan.

Koizumi can also blame *gaiatsu*—foreign pressure.

Yanagisawa recently dropped his opposition to the International Monetary Fund's request to examine the books of Japan's major banks. An IMF team is expected by yearend. They're most anxious about some \$700 billion worth of so-called "classified credits," or shaky loans. If the IMF concludes the loans are duds, Koizumi would

have another excuse for action.

The question now is how much money the banks need and on what terms they will get it, a subject the Diet is expected to take up soon. Goldman, Sachs & Co. economist Tetsufumi Yamakawa says that if the debt is as big as the IMF fears, the banks' operating income and reserves would cover less than half the needed provisions—even if they spread the write-offs over three years. The Bush Administration's envoy on this issue, former U.S. Resolution Trust Corp. Chairman L. William Seidman, says the government will need to sell some \$100 billion in bonds to fund future operations of the RCC. Painful. Koizumi's room to maneuver keeps shrinking though. Catastrophe occurred. It's a different story now.

Bremner is Tokyo bureau chief.



FACING UP

The U.S. disaster may give him the political cover he needs for a capital injection

Ichi Kangyo Bank, Fuji Bank, and the Industrial Bank of Japan—will suffer a \$2.2 billion loss for the six months ending Sept. 30. Heizo Takenaka, State Minister for Economic & Fiscal Policy, told reporters on Sept. 17 that up to 30 other big companies are likely to follow Mycal soon.

Something has clearly goaded the banks into action—probably regulators applying behind-the-scenes pressure. The signs are subtle. After a Cabinet meeting on Sept. 17, Yanagisawa said that the Resolution & Collection Corp., Japan's fledgling bailout



STICKING TO PROJECTIONS: Co-CEOs Rainer Hertrich and Philippe Camus

scheduled for delivery over the next few months won't be affected much because airlines would have to pay stiff penalties for last-minute cancellations. But those deliveries will only add to a glut of planes the depressed industry doesn't need now, making it even more likely future deliveries will slow sharply. That, in turn, would cut deeply into Airbus' cash flow, because 90% or more of an aircraft's purchase price is generally paid on delivery.

"MOST AT RISK." Suddenly, the high-powered salesmanship that boosted Airbus' share of the global commercial jet market to roughly 50% over the past decade looks like a mixed blessing for EADS. What frightens investors is that EADS gets 70% of its revenues and nearly all its profits from Airbus. Boeing, by contrast, has pushed to diversify and now gets less than 60% of revenues from the commercial jet business. EADS has a big defense business, making everything from helicopters to spy satellites, but it mostly loses money. "Of all the companies in the aerospace sector, EADS is the most at risk from the problems going on in this industry now," says analyst Howard Wheeldon of Prudential Bache in London.

How could EADS respond if the downturn spirals out of control? Layoffs at Airbus would be a last resort because of tough antilayoff laws and likely political opposition from European governments. More probable, EADS would push Airbus to delay the launch of its A380 superjumbo, which will require an estimated \$11 billion in startup spending. Although EADS says the first planned delivery of the plane is on track for 2006, the deadline could slip if Airbus salesmen can't rustle up more than the 48 orders logged so far.

Growing financial pressure will complicate the task of managing EADS. The company was formed last year through the merger of leading French, German, and Spanish aerospace companies that are still regarded by their governments

as national champions. EADS not only has two CEOs but two headquarters, in Paris and in Munich. And it shares ownership of Airbus with BAe Systems of Britain. Knitting together such a company would be tough in the best of times, let alone today. For EADS, that pain in the Achilles' heel may not go away soon.

By Carol Matlack in Paris, with Stanley

ROPE

WHY AIRBUS COULD GO INTO A DIVE

EADS' mainstay could get hammered by canceled orders

was a wound to the Achilles' heel of Europe's biggest aerospace company. Only a few months ago, the giant European Aeronautic Defence & Space Co. (EADS) was chugging along, buoyed by the performance of its largest unit, commercial jet maker Airbus Industrie. The pace began to slow in June as a slumping global economy forced Airbus to scale back sales forecasts. Then came the attack on the World Trade Center, followed by a sharp drop in air travel and a cascade of bankruptcy warnings in the global airline industry. Analysts now foresee a stream of canceled and delayed aircraft orders that by 2003 could curtail worldwide deliveries at as little as half of recent levels. On Sept. 18, Airbus rival Boeing Co. announced it would lay off up to 10,000 workers.

Now the heat is on EADS, which owns 80% of Airbus. Spooked investors have driven EADS shares plunging nearly 40% since the terrorist attacks, prompting the company on Sept. 19 to announce it would buy back 1.3% of its shares. EADS Chief Executive Philippe Camus says the company is scaling back next year's production target to about 350 planes, down from this year's figure of 320 but well below the 400 Airbus had been expecting only a few months ago. As production slows, Airbus will let go some temporary workers and reduce subcontracts.

But it doesn't plan to lay off any of its 44,000 employees. And, as EADS prepared to release first-half results on Sept. 20, Camus said the company was sticking with projections of a 15% rise in pretax earnings this year, to \$1.3 billion, on sales of \$25 billion. "We are still growing," Camus says. "We do not have a need to reduce dramatically."

Still, Camus and his co-CEO, Rainer Hertrich, have plenty of reasons to worry. US Airways Group Inc., which is awaiting delivery of 43 Airbus planes, could declare bankruptcy. Lufthansa is shelving plans to order up to 15 Airbus A380s, and Britain's Virgin Atlantic Airways is reviewing its aircraft orders. To be sure, planes



What's Powering EADS Profits

	REVENUES*	OPERATING INCOME*
AIRBUS	\$13.9 billion	\$1.2 billion
MILITARY AIRCRAFT AND HELICOPTERS	4.7 billion	279 million
DEFENSE ELECTRONICS AND CIVIL SYSTEMS	2.7 billion	-103 million
SPACE	2.3 billion	65 million
MILITARY TRANSPORT	300 million	-59 million

*2000

Data: European Aeronautic Defence & Space Co.

GERMANY

THE SEXING-UP OF OPEL

GM's dowdy carmaker is doing some major image work

In Europe these days, the one thing General Motors Corp. seems to be good at is losing money. Lots of money. GM lost \$240 million in Europe the first half of the year, almost all of it coming from its Germany-based subsidiary Adam Opel. Prudential Securities Inc. forecasts GM will lose \$600 million in Europe this year, after dropping \$676 million last year. When it comes to a bland brand image and a reputation for sloppy quality, Opel is a frontrunner.

Time for a new image. And that's what Opel tried hard to project at the Frankfurt Auto Show in mid-September. There it introduced concept vehicles and new models all built around an intriguing idea: to transform many of its standard European sedans and coupes into fun-driving utility vehicles. Basically, the new models are taller versions of small

European cars, which give drivers the storage space and commanding ride height of a sport-utility vehicle—but without the bulky size of American SUVs. Opel also will add flexible seating and storage to its conventional models. Says GM Europe boss Michael J. Burns: "The idea is German engineering with versatility and flexibility."

For Opel, these are bold moves. The carmaker has been known over much of the last decade for its timidly designed, mainstream sedans and compacts—real follow-the-leader stuff. Now it wants to lead the market as Europe's drivers develop a new taste for sport-utility and related vehicles. Thus Opel's Signum sport wagon, shown at the Frankfurt Show, has rear seats that fold over, leaving a completely flat floor for gear and a pair of storage boxes. Opel plans to launch three



more utility vehicles by 2005, based on platforms from its Vectra, Astra, and Corsa models, analysts say.

If Opel can beat its competitors in the market with distinctive vehicles, the company can lure more buyers and fetch better prices. "Commanding a premium is a reward for building good products," says Opel Chief Executive Carl-Peter Forster. He should know: Before taking the helm at Opel on Apr. 1, Forster was a key player in developing the sharp, styled, richly profitable 5 series for BMW.

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SUCCESS STORY: Opel's Zafira compact minivan has been its one big hit

still has to shake its reputation for poor quality. Meanwhile, competitors are moving in. Renault has launched an all-wheel-drive version of its Megane Scenic—a rival to the Zafira. Volkswagen will launch a small utility van off its Golf subcompact, while Ford will be selling a similarly designed vehicle built off the Focus compact. "I don't think anyone can own versatility," says Ford of Europe Chairman and CEO David W. Thursfield. "It's like trying to own four wheels."

It's also very hard, in the crowded European car market, to regain lost share. Opel's has fallen to 10.5% this year, from 12.7% in 1993. Nigel Griffiths, analyst with DRI-WEFA in London, forecasts that Opel's share will remain static at about 10.3% in the next two years. At the same time, the company isn't winning new buyers in the profitable large-sedan segments. And it is nowhere in the luxu-

ry market. Its sales growth has come from the Zafira and the Polish-made Agila subcompact, which sells for about \$8,500. Even Opel execs expect a tough turnaround. Rebuilding the brand "takes seven years," concedes Alain Uyttenhoven, Opel's director of brand management. "You still have models in the pipeline that don't fit the strategy."

That's why Opel continues to pursue the dreary business of shrinking the company. GM aims to cut European capacity by 480,000 vehicles and is negotiating with unions for even more cuts. Mean-

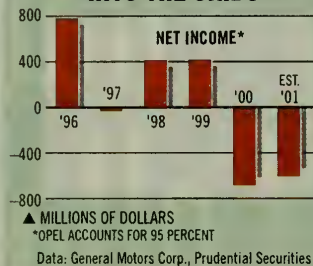
while, GM and Fiat—of which GM owns 20%—will merge their engine development efforts. That will reduce costs by \$900 million for each auto maker by 2007. Says GM CEO G. Richard Wagoner Jr.: "It's hard to imagine that you can [ever] cut costs too much." Trouble is, drivers don't buy costs. They buy cars. Opel badly needs the right strategy to sell them.

*By David Welch
in Frankfurt*

SIGNUM



**GM EUROPE
HITS THE SKIDS**



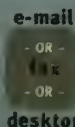
Forster's team developed the sport-strategy after studying the details of its one bona fide success of late. Drivers love the zippy Zafira compact minivan, whose \$18,000 sticker price is 5% above competing models. The Zafira's seats can be reconfigured to hold more than seven passengers. Such features have clicked with buyers, who see the Zafira as an affordable alternative to large sedans. Forster, a proven winner, thinks Opel has a winning strategy. Yet Opel

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CIO, Celestica Inc.



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Customer Organization,
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Pradeep Sindhu,
Vice Chairman, CTO,
and Founder, Juniper
Networks, Inc.

ADDITIONAL CONFIRMED SPEAKERS

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Panasonic Company National

Daeje Chin, President and CEO, Digital
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MEXICO

MEXICO'S WAGON IS HITCHED TO A FALLING STAR

A U.S. recession would hurt even worse south of the border

Every day, thousands of trucks rumble through border checkpoints, bearing cars and computers and other cargo to the great markets of *El Norte*. For the better part of a decade, Mexico has worked mightily to hitch its economy to that of its northern neighbor. Now the U.S. could be sliding into a deep recession after a wave of terrorist attacks, and Mexico, too, will pay the price. From border boomtowns such as Ciudad Juárez to the seaside resort of Cancún, all will feel the effects of a U.S. retrenchment.

Coming just five days after President Vicente Fox's state visit to Washington, the bombings extinguished hopes that

are manufactured goods, most of them bound for the U.S. Demand for big-ticket items such as automobiles will probably be the worst hit. But Gil says he expects that shipments of televisions, computers, and household appliances such as stoves and refrigerators will also suffer. Another likely victim: tourism. "The U.S. economic crisis and fear of flying will make tourism one of the most affected sectors," says Francisco Madrid, undersecretary of planning at the Tourism Secretariat. Officials predict that revenues will fall by 5% next year, to \$7.6 billion. Yet an-

LOW GEAR

Demand for big-ticket items such as autos will be the worst hit



NORTHERN EXPOSURE

ECONOMY Growth will cool to 0.6% this year and will be lucky to reach 2.5% in 2002

EXPORTS Exports of manufactured goods, set to hit \$161 billion in 2002, could fall to \$143 billion

FOREIGN DIRECT INVESTMENT Could drop from a hoped-for \$20 billion to just \$13 billion in 2002

TOURISM Revenues for the sector, a major source of foreign exchange, may fall from \$8 billion to as low as \$5 billion

REMITTANCES Money sent home by Mexicans working in the U.S. could drop from \$9 billion to \$6 billion

Data: ECANAL, Tourism Secretariat

the U.S. economy was on the verge of recovery. Economists now say Mexico will be lucky to post 0.6% growth this year. That's way down from the 4.5% the government had initially projected. Mexico had already been faltering before the events of September. Exports to the U.S. fell by more than 4% year over year in June and July and are headed further south. More than 500,000 workers have lost their jobs this year, as companies scale back production. "If the U.S. doesn't recover quickly, it is going to be hard," says Finance Secretary Francisco Gil.

The damage to the Mexican economy could be widespread: 90% of its exports

analysts warn that revenues could be as low as \$5 billion if many Americans decide to stay home.

Washington's efforts to beef up airline security could also take a toll on Mexican businesses. Passenger flights will no longer be able to accept cargo shipments. That will boost transport costs for electronics manufacturers in Guadalajara and Monterrey that supply components to factories in the U.S. on a just-in-time basis. "Timing [of deliveries] is going to be more unpredictable, so it's going to cost more in terms of production costs," Gil says. And businesses that use highway transport are facing long delays at customs crossings along

the U.S.-Mexico border. Crossings that normally take half an hour were taking as long as two hours one week after the bombings, according to Delphi Automotive Systems Corp.

Some Mexican companies have bigger worries than whether their shipments get to their destination on time. Wages in many sectors are rising faster than inflation, which is expected to end the year at 5.5%. In early September, 12,300 workers at Volkswagen's New Bee plant in Puebla secured a 14% increase in wages and benefits after a 15-day strike. Workers at the state-run oil company, Petróleos Mexicanos, recently won an 8.5% hike, as did flight attendants at Mexicana Airlines. "If companies and the government continue to reach settlements quickly to avoid strikes, we will quickly price ourselves out of the market," says Gil.

PLUNGE. The trend toward high-wage settlements could also dim Mexico's attractiveness in the eyes of foreign investors. Volkswagen spokesman Thomas Ka says the company has shelved plans for new projects for the time being. "Mexico definitely is no longer a low-wage country," he says. Plunging sales at home and in major export markets may force some multinationals to follow suit. "Large international companies are heading toward much more pessimistic outlook, and investment in a country like Mexico will be a lower priority," says Sergio Ramírez de la O, president of Economic Analysis for Company Planning (ECANAL), a Mexico City consultancy.

One of the areas where Mexico stands to benefit from the current crisis, is if oil prices skyrocket in response to war in the Middle East. The price of Mexico's crude mix has risen 28% in the last month. And the U.S. and Mexican economies are so closely wedded that when demand picks up in the U.S., orders should flow to Mexico immediately. For now, that recovery is nowhere in sight.

By Geri Smith in Mexico City

BusinessWeek online

For an interview with Mexico's Finance Secretary, go to the Oct. 1 issue at www.businessweek.com.

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How to Cope In the Wake of Disaster

Simply recognizing symptoms of stress can help

BY CAROL MARIE CROPPER

In the days following the World Trade Center disaster, workers in New York's midtown office towers rushed for the elevators at the slightest rumor of a fire or bomb. Victims of Oklahoma City's 1995 disaster returned to their old psychiatrists. Across the U.S., people passed fitful nights as televised scenes of fiery jet crashes replayed in their heads.

Certainly, the deadly attacks on the World Trade Center in New York and the Pentagon in Washington will inflict their greatest psychic pain on those who lost loved ones or experienced the horror firsthand. Millions of others across the country, however, are also experiencing emotional trauma. "An event like this affects everyone's mental health," says Dr. Stuart Yudofsky, chairman of the psychiatry department at Houston's Baylor College of Medicine. Watching such dramatic and violent events, even on TV, and knowing that thousands of Americans have likely died can produce acute stress. "We'll probably all have some of the symptoms," says Dr. Arthur Rousseau, an Oklahoma City psychiatrist who worked with victims after the bombing that killed 168 there.

Just realizing that a certain amount of psychic upheaval is normal and recognizing its symptoms can lessen the anxiety. Difficulty sleeping, eating, or concentrating, irritability, and jumpiness—especially when a plane flies overhead or when around tall buildings—are all possible symptoms.

Those experiencing more severe stress may find it hard to keep the horrible images from popping back into their minds or they may suffer

from nightmares. Others may go out of the way to avoid all mental cues—like the Brooklyn residents seen walking with their heads turned away from the ravaged Manhattan skyline just across the East River. Some may experience emotional numbness, says Dr. Michael Blumenfeld, a member of the American Psychiatric Assn. committee on disasters. Survivors who narrowly escaped the carnage could feel guilty or depressed, he adds.

LESS TV. Children might have bad dreams or worry about the death of their parents, says Dr. David Fassler, a psychiatrist who specializes in helping children deal with stressful events. Young kids may become clingy and regress to earlier behavior, such as wanting

to sleep with their parents or wanting the bed. Parents should respond by creating opportunities for their children to talk,

The Aftermath

perhaps having younger children draw pictures to express their feelings. Questions should be answered honestly, in a way the child can understand, says Dr. Fassler. Be there as your child watches TV reports and, especially for your children, limit how much news they see. Return children to their normal routine to re-establish a sense of security. Keep in mind that children take their emotional cues from watching you.

Most Americans will not experience debilitating symptoms and will recover once the crisis past, says George Bonanno, who has done grief studies at Columbia University in New York. Some, however, will be surprised by the depth of their response. Rescue workers may be hit by a delayed reaction, six months or even a year later. Barbara Crown, a veteran Red Cross vol-

Dealing with Our Tragedy

The events of Sept. 11 have caused varying levels of distress even in those not directly affected by the tragedy. Although most people's symptoms won't be severe, here's what to expect and how you can help yourself and those you love

POSSIBLE SYMPTOMS

- Difficulty sleeping, nightmares
- Jumpiness, trouble concentrating
- Loss of appetite or overeating
- Recurring thoughts of the event, or, in severe cases, flashbacks
- Irritability
- Feelings of emotional numbness or detachment
- Avoiding reminders
- In children: anxiety, clinging, regression to earlier behavior, such as bed-wetting

PSYCHIATRISTS' RECOMMENDATIONS

- Don't be afraid to discuss the event or show your emotions
- Take time away from the tragedy by going to a movie or reading a light novel
- Direct emotions into a positive vein by volunteering or donating
- Parents: Reassure children they are safe, answer their questions and return them to their normal schedule as soon as possible



who counseled some of the 700 licensed mental-health volunteers comforting victims in New York in the days after the attack, says anyone who help in such disasters can suffer post-traumatic stress symptoms, as well.

Many who survived the ordeal will be haunted by images of those who did not make it. One World Trade Center survivor, says Dr. Blumenthal, recalled the sight of people left behind in wheelchairs because they couldn't maneuver the stairs. Fred Rickert, an electrician who was working on the 34th floor of the north Trade Center tower before it collapsed, stood on the New Jersey shore after being evacuated by ferry. Rickert escaped uninjured but appeared shaken by the memory of the 25 to 30 firefighters he passed on the stairs on their way into the doomed building.

VERSION. People who have lived through other traumas will be hit hard by scenes from the Sept. 11 attacks. Oklahoma mental-health professionals on local TV stations and manned caller hotlines as many in that city relived memories of the bombing there. World War II vets recalled the sight of kamikaze pilots. Survivors of rape, sex traffic accidents, or violent deaths of loved ones, are also more susceptible. Anyone predisposed to phobias or anxiety is vulnerable.

Talking about the events and being open with emotions can help ease the stress, says Dr. Rousseau. He recounted the story of an Oklahoma City woman who dealt with her grief six years ago by pulling into a convenience store where never she felt overwhelmed and buying a pack of gum as an excuse to talk with the clerk. Not all professionals agree here. If emotional talks and repeated discussions don't feel right

for you, don't feel compelled to talk, advises Dr. Sally Satel, a Washington (D.C.) psychiatrist. Bonanno's studies indicate that many people suffer more for verbally dwelling on their losses. For one thing, continually talking about negative emotions can drive away friends and relatives needed for support. "I think the idea that everyone needs to be expressing it and reliving it is wrongheaded," says Bonanno.

One strategy recommended by psychiatrists is to take a break from the tragedy. Turn off the coverage on TV. Read a light novel or take in a movie. To regain a sense of control and channel your emotions in a positive way, donate blood, food, or cash to the rescue effort. Children might write letters to firefighters or the mayor of New York. If stress symptoms keep you from functioning at work, in school, or socially, or persist for more than a month, seek professional help.

As horrific as the events of Sept. 11 are, says Dr. Rousseau, there are some positive emotional aspects. Many of his regular psychiatric patients have told him the tragedy helped them put their own problems into perspective. And there is inspiration to be taken from the stories of heroism: the New York City firefighters who lost their lives trying to save others and the passengers on United Airlines Flight 93 who may have foiled their hijackers' plot. Disasters can bring out people's compassionate side. Dr. Rousseau recalled the New York City volunteers who arrived to help out in Oklahoma City and how amazed they were by the generosity of the local people. "They said it never would happen in New York." Now, he said, the world is seeing they were wrong.

With Kate Murphy

Rescue workers may experience a delayed reaction similar to that of the victims they have counseled, says veteran Red Cross volunteer Barbara Crown

BUYBACKS,
EARLY
RETIREMENT, NO
SHAME AT USX

BusinessWeek Investor

Don't Let Panic Rule Your Portfolio

If you had a sound plan before the attack, stay the course

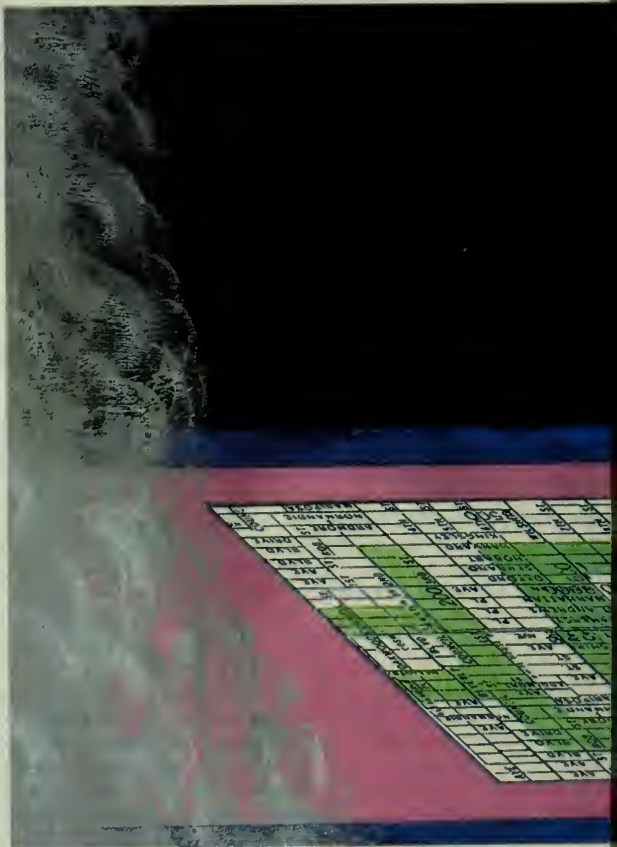
BY ANNE TERGESEN

During a time of national crisis—particularly one whose epicenter lies in the heart of the nation's financial capital—it's natural to feel anxious about your financial security. But if you have a well-crafted, diversified plan that reflects your goals, risk tolerance, and investment time frame, stifle the urge to rip it up and flee to safe havens, such as cash or bonds. "A sound long-term investment plan assumes there will be bad times—really bad times," says Dan Moisand, president of Optimum Financial Group in Melbourne, Fla. So Moisand and many of his financial-planning colleagues are advising their clients to sit tight.

At least that's what they're telling those who asked. Numerous financial planners contacted said their phones were silent for most of the week following the attacks on the World Trade Center and Pentagon on Sept. 11. Numbed by incomprehensible events, most people did not dwell on their finances. But as the reopened markets experience wide swings, the questions will come to the fore.

Advisers say they'll tell most people to retain their high degree of exposure to stocks. Equities typically make up a large portion of investment programs intended to pay off in five or more years. Stocks tend to outperform bonds over long periods and, historically, have been the most reliable route to college or retirement.

PAST CRISES. Although current events are unprecedented, history suggests that those who stick with stocks in times of national crises will be rewarded. That may seem hard to believe, given the 7.13% fall in the Dow Jones industrial average on Sept. 17, the first day of trading after a four-day halt. Nonetheless, in 14 prior national crises, the Dow rebounded to finish an average of 0.5% higher three months later and 4% higher



within six months. Returns after six months were negative in only four cases, including F Harbor and the Arab oil embargo, according to Ned Davis Research, a Venice (Fla.) firm compiles financial-market research.

The Federal Reserve Board and other central bankers are doing their part to help by cutting interest rates and pumping liquidity into the financial system. That brought the Fed funds rate to the

lowest level since the Gulf War. And the Fed indicated it will cut more if needed. While the September terrorist attacks nearly guarantee a global recession, the U.S. economy has great strengths that should bear out over the 20-plus years upon which most investment plans are based.

In fact, many financial planners are advising

Financial Planning

nts with cash to buy stocks in the coming ks, especially on the market's dips. "You hate take advantage of a tragedy, but usually it's a d time to buy when people are panicking," s Ronald Ruge, president of R.W. Ruge in emia, N.Y. Just be prepared for some gut- nching volatility along the way. In the month wing past crises, investors had to withstand ines of as much as 23.6%, according to Ned is Research.

J.P. Morgan, for one, is recommending big, l-known companies whose earnings are tively insulated from bad times and whose ks typically trade in large volumes. mples include utilities, drugmakers, and con- er product concerns such as Dominion Re-

items such as automobiles also stand to suffer if—as economists predict—American consumers clamp down on spending.

Although you should never rush to make sweeping changes in your financial plan, this is a good time to reassess your risk tolerance, if the bear market hasn't already made you do that. One of the worst things investors can do is "make major decisions in a time of emotional stress," says Joel Ticknor, a financial planner at Ticknor Financial in Reston, Va. Indeed, selling into a crisis "can result in receiving fire-sale prices," says Paul Baumbach, president of Mallard Asset Management in Newark, Del.

But if after a decent interval you still feel you have gone overboard in your exposure to

Industries to avoid in the near future, advisers say, include airlines, insurers, hotel chains, and autos

Investments to Consider

INVESTMENT	REASON	EXAMPLES
COMMODITY FUNDS	Oil and gold prices rise during wartime. Good diversifiers and inflation hedges.	Oppenheimer Real Asset or Vanguard Precious Metals funds
CONSUMER PRODUCT STOCKS	They provide things people need and must purchase.	Food and personal-care companies such as Gillette, Heinz, Kellogg, Kraft Foods, or Consumer Staples Select Sector SPDR
DEFENSE STOCKS	Terrorist attack will increase defense spending.	Lockheed Martin, Northrop Grumman
DRUG STOCKS	Drug-company earnings are not tied to the economy's ups and downs.	Merck, Pfizer; Fidelity Select Health Care or Vanguard Health Care funds; Pharmaceutical HOLDERS
HEDGE-TYPE FUNDS	Low correlation with the broader market.	Leuthold Core Fund, Calamos Market Neutral Fund, Enterprise Mergers & Acquisitions
MONEY MARKET FUNDS	Cash is king during periods of economic stress.	Vanguard Prime Money Market Fund
REAL ESTATE INVESTMENT TRUSTS	REITs are good diversifiers and pay high dividends. Office rents in New York are likely to rise.	Vornado Realty Trust, Columbia Real Estate Equity Fund, or iShares Dow Jones U.S. Real Estate Index Fund
SHORT TERM BONDS	Relatively safe and higher yielding than money-market instruments.	U.S. Treasuries and high-grade corporate bonds with maturities of less than three years
INFLATION-PROTECTED SECURITIES	Good diversifier and inflation hedge.	I-Bonds and TIPS, also Vanguard Inflation Protected Securities Fund

ces, Cardinal Health, Pfizer, and PepsiCo. Thomas Grzymala, president of Alexandria Financial Associates in Alexandria, Va., has his on defense industry contractor, Lockheed tin, as well as General Electric and Alcoa— of which he describes as cheap. And Morris strong of Armstrong Financial Strategies ew Milford, Conn., is on the lookout for real e investment trusts (REITs) that own com- ial property in New York City. Such REITs— ado Realty Trust is an example—are likely enefit from rising rents, as companies imed by the attacks scramble for a limited ly of available office space.

OFF. Meanwhile, industries to avoid in the -term include those most affected by last c's tragedy: insurers, airlines, and hotel as. Retailers and manufacturers of big-ticket

stocks, scale back. Whatever you do, though, maintain a commitment to diversification. "The past 18 months have shown us that concentrating investments in any one area can be disastrous," says Carl Camp, president of Eclectic Associates in Fullerton, Calif. Indeed, while fallen technology stars have been mired in a bear market this year, bonds, as well as some mutual funds that invest in value stocks and the stocks of small companies, have done relatively well.

A sound investment strategy remains just that—through an economic downturn, a national crisis, or both. So if you had a sensible financial plan two weeks ago, keep a cool head. But if recent tragic events have exposed flaws in your long-term plan, get to work. Just remember to keep your eye on your long-term goals.

With Lewis Braham and Susan Scherreik

When Buybacks Are Signals to Buy

Only some stocks being repurchased are good deals

BY ANNE TERGESEN

As part of a package of measures to help stabilize the financial markets, the U.S. Securities & Exchange Commission temporarily waived restrictions on companies buying back their shares. The regulators hope that if companies are given carte blanche, they'll stand ready to buy what nervous investors would be selling. Indeed, on Sept. 17, over 100 companies announced billions in buyback plans. This alone won't heal the market, but it sends a signal that companies believe their shares are undervalued.

Stock buybacks aren't new. In 1987, in fact, the SEC similarly opened the door for massive share repurchase programs that ultimately helped the market recover from the crash.

Of course, buyback programs are not just announced in crisis situations. Many major corporations have ongoing buyback authorizations that allow them to periodically go into the market to purchase their shares. That's because these companies often can't find enough profitable new business ventures to soak up the cash they generate.

They prefer to return cash to shareholders through buybacks rather than dividends because dividends can't be cut without inflict-

ing serious damage on a stock's price, but buybacks can be quietly turned off. No disclosure required. Shareholders also like buybacks because only those who choose to sell trigger bills, whereas cash returned as dividends is treated as ordinary income.

Companies that announced buybacks on Sept. 17 include Allstate, Bank One, Cardinal Health, Goodrich, and Siebel Systems. But plenty of companies such as Boeing, Caterpillar, and General Motors have yet to complete programs unveiled during a buyback boom that remained strong until last year (table). The healthier companies among them were no doubt purchasing their shares.

EYES OPEN. Until the recent spate of announcements, the number of new buyback programs for 2001 had fallen to the lowest level in years. That's because corporations, hit hard by earnings shortfalls, were conserving cash rather than earmarking it for the purchase of their shares. And indeed, the slump might crimp the number or size of the buyback programs. On the other hand, if stocks get cheap enough, there aren't a lot of other good investment opportunities out there, corporate boards may decide that buying what they know best—their own company—makes the most sense.

Either way, it pays to keep an eye on buyback activity. One place to monitor new announcements is www.theonlineinvestor.com/buybacks.shtml. Companies that announced buybacks outperformed similar companies that didn't by an average of 23 percentage points over the 12 years following programs announced between 1991 and 1996. That's up from 11 points in the 1980s, says David Ikenberry, a finance professor at Rice University's Jones Graduate School of Management.

As the returns earned by financial newsletters and Web site, Buybackletter.com, indicate, the phenomenon has remained strong. According

Scores of companies announced billions of dollars in buyback plans on Sept. 17. Similar plans after the 1987 crash helped the market recover



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Hulbert Financial Digest, which tracks financial newsletters, Buybackletter.com's recommended stocks are up 10.9% over the 12 months that ended in August, vs. a 24.4% decline for the Standard & Poor's 500-stock index. Over the three years ending in August, the newsletter's picks have returned an average of 16.4% a year, while the S&P 500 is up 7.1%.

Although there's no guarantee that companies announcing buybacks will repurchase so much as one share—never mind the thousands typically targeted—Corporate America has a surprisingly good track record when it comes to following through on its buyback pledges. In fact, since 1989, S&P 400 companies have achieved completion rates of about 88% on the buybacks they have announced, says Frederic Escherich, head of mergers-and-acquisitions research at J.P. Morgan Chase.

Still, not all companies engaged in buybacks are good investments. You don't gain much unless a program actually reduces the number of shares outstanding. This is key, because by doing so, a company is able to spread its earnings among fewer shares. The result is an increase in earnings per share—a measure of corporate health that heavily influences stock prices.

The greater the percentage of shares a company retires (the average buyback program aims for a 5% reduction), the better its stock generally

back enough shares to offset the number it issues when employees exercise stock options. Take Microsoft. Over the nine months that ended on Mar. 31, the software giant's cash flow statement indicates that it spent \$4.4 billion on buybacks—or \$3.3 billion more than it received from issuing new stock. However, by comparing a footnote devoted to "earnings per share" in the Mar. 31 report to one from a report issued nine months earlier, you can see that the average number of common shares actually rose.

(Since the share base grew because of employee stock options—which are exercised at below market prices—the new shares netted fewer dollars than Microsoft spent retiring its shares.)

BUY SIGNAL? Once you make sure shares outstanding have declined, look for buyback stocks that are undervalued compared with their peers, says David Fried, editor of Buybackletter.com. When a company that announces a serial buybacks announces an unusually large program vs. its normal one, "it may be a signal of undervaluation," says Escherich.

Even if you think a stock is a good deal, don't touch a buyback if executives are selling. Why buy if insiders want out? One recent example: Time Warner. Since the media giant announced a \$5 billion buyback on Jan. 18, several high-ranking executives have sold some personal holdings. The stock declined from \$49.77 to \$38.50 before the market's Sept. 17 fall.

Buybacks can also backfire in the current climate of economic weakness, so you want to focus on financially sound companies. Since 2000, bond rating agency Moody's Investors Service has downgraded the credit quality of a record number of companies, including Nordstrom, Campbell Soup

and Hasbro, at least in part because of buybacks. "Taking money out of a business during a period of economic weakness is risky," says John Puchalla, an economist for Moody's. When a company's bond rating falls, it is forced to pay higher interest rates, which can negate a buyback's positive impact on earnings. For this reason, Fried prefers companies that execute buybacks with cash, as opposed to debt, and that have credit ratings of B- or better.

Despite the risks, history shows that buyback stocks do outperform. Keep that in mind as you assess stocks' prospects in the coming months.



Buy What Companies Are Buying

Many companies have buyback programs, but not all are reducing the number of shares outstanding. Here are some companies that are retiring shares, according to Buybackletter.com, a newsletter and Web site.

STOCK/SYMBOL	SHARE REDUCTION*	STOCK/SYMBOL	SHARE REDUCTION*
ARCHSTONE COMMUNITIES TRUST (ASN)	-12.8%	GENERAL MOTORS (GM)	-11.6
BOEING (BA)	-11.2	HIGHWOODS PROPERTIES (HIW)	-11.0
CATERPILLAR (CAT)	-1.5	NSTAR (NST)	-8.8
CRESCENT REAL ESTATE EQUITIES (CEI)	-11.6	REX STORES (RSC)	-24.4
DANA CORP. (DCN)	-2.9	R.J. REYNOLDS TOBACCO (RJR)	-4.2
OGE (OGE)	-17.4	TXU (TXU)	-2.1
EASTMAN KODAK (EK)	-5.9	WINN-DIXIE STORES (WIN)	-2.8

*Decline in shares outstanding over the 12 months through 8/31/01

Data: Buybackletter.com

fares, says Ikenberry. That's why Buybackletter.com won't recommend a stock until the number of shares outstanding falls by at least 3% from the prior year.

To find the number of shares outstanding, look in the footnotes to the financial statements. One section, typically labeled "earnings per share" or "net income per share," lists the average number of shares outstanding and the figure from a comparable period in the prior year.

Sometimes, despite a buyback, shares outstanding stay the same or even rise. Typically, this happens when a corporation doesn't buy



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HOW TO CASH OUT OF YOUR COMPANY



BY TODDI GUTNER

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The net unrealized appreciation rule gives retirement-plan participants a considerable tax break when they sell off company stock, even if they are under age 59½

We should all have such problems. In January, 2000, after a 17-year career with brokerage firm Charles Schwab, Michelle Seymour had accumulated nearly \$5 million in assets in her 401(k) and employee stock ownership plans (ESOPs). Although just 38 at the time, she decided to opt out of her job in a year. "I wanted to retire and enjoy the wealth I had built," says Seymour, who managed Schwab's Bakersfield (Calif.) branch office.

So what were her problems? Nearly 85% of her assets were in Schwab stock, and she clearly needed to diversify. Plus, she wanted to get her hands on a chunk of that money immediately without paying the taxes and early withdrawal penalties that could have eaten up 40% of her nest egg.

The answer to the first problem wasn't hard to fathom. At the beginning of last year, Seymour began selling chunks of Schwab stock each week and reinvesting the proceeds in stocks and mutual funds. Unfortunately, after going through a big run-up in the 1990s, Schwab shares were sinking along with the rest of the market. By the time she retired in January, 2001, her accounts were worth \$3 million, and she rolled over \$2 million of that into an individual retirement account.

DAMAGE CONTROL. The second problem—withdrawing the remaining \$1 million without taking a huge tax and penalty hit—was trickier. After speaking with several longtime Schwab colleagues and consulting with attorneys and a financial planner, Seymour decided to use a little-known tax provision called the net unrealized appreciation rule (NUA). It allows retirement plan participants who receive distributions of their employer's stock to significantly limit their income-tax liability and early withdrawal penalty if the participant is under age 59½.

The NUA rule works like this: When you leave your job, you take a distribution of the entire balance from one or more of your tax-deferred

plans within one year. You invest the distributions in a taxable brokerage account in your name. You then pay ordinary income taxes on the average cost basis of the stock, not current market value on the day the assets are distributed. (The plan administrator can provide the average cost-basis information.)

The difference between the cost basis of shares and their fair market value at the time of distribution from the plan is the net unrealized appreciation. Each time you sell some of the shares, you will pay taxes on any of the NUA, but then they will only be at the 20% long-term capital gains rate.

Look how this worked for Seymour (table).



Minimizing Taxes, Maximizing Assets

Michelle Seymour wanted to cash out \$1 million of her retirement assets in Charles Schwab stock, while minimizing the tax impact. Here's how she used the little-known net unrealized appreciation rule to do it

- Put \$1 million worth of Schwab shares into a taxable brokerage account.
- Paid ordinary income taxes on the stock's "average cost basis," which was just \$30,000. At the 36% rate, that's \$10,800.
- Paid an additional 10% withdrawal penalty of \$3,000 (10% of \$30,000).
- Tax hit for the entire transaction came to \$13,800.
- For future sales, she will pay a 20% capital-gains rate on any shares sold from a taxable account.

She put \$1 million worth of her Schwab stock in a taxable account. The average cost basis was an astoundingly low 32¢ per share, or \$30,000 in total. Therefore, Seymour paid ordinary income tax on only \$30,000, estimated to be \$10,800, since she was in the 36% bracket. Because she withdrew the shares before age of 59½, she owes an additional 10% early withdrawal penalty. But, like the others, the penalty is only on average cost basis. "So if you have a 10% penalty on \$30,000?" says Chris Fahlund, senior financial planner with T. Rowe Price Advisory Service. "That's only \$3,000." As Seymour sells the Schwab shares from her taxable account, she owes only 20% in capital gains taxes on the NUA.

Seymour still has \$700,000 worth of Schwab shares in her taxable account, about 23% of her combined assets. "It's still more than I want, but I continue to sell a little bit every week," Seymour, who admits she doesn't want to pay more capital gains taxes now, she thinks the stock will eventually rebound. In respect, she should have sold more sooner. Still, says Seymour, who is taking time

to be with her two children and rethink her career, "I feel confident about my retirement strategy because I educated myself about what I needed to know."

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ATTENTION ALL PERSONS OR ENTITIES WHO PURCHASED CERTAIN "INDIRECT VITAMIN PRODUCTS" (as defined below) BETWEEN JANUARY 1, 1990 AND DECEMBER 31, 1999

PLEASE READ THIS SUMMARY NOTICE CAREFULLY AND IN ITS ENTIRETY

WHY SHOULD I READ THIS SUMMARY NOTICE?

Your rights may be affected by class action lawsuits and/or lawsuits filed by the State Attorneys General pending in the District of Columbia, Arizona, Florida, Hawaii, Idaho, Illinois, Kansas, Maine, Michigan, Minnesota, Nevada, New Mexico, New York, North Carolina, North Dakota, Puerto Rico, Rhode Island, South Dakota, Tennessee, Vermont, Washington, West Virginia, and Wisconsin (the "Settling States"). Courts in the Settling States have preliminarily approved a settlement agreement (the "Settlement Agreement") providing for partial settlements of these lawsuits, appointed counsel for the Settlement Classes ("Class Counsel"), and scheduled hearings to consider fairness, adequacy, and reasonableness of the proposed settlements.

WHAT ARE THE LAWSUITS ABOUT?

Plaintiffs, on behalf of themselves and all other similarly situated persons and entities, together with the attorneys general of each of the Settling States (the "State Attorneys General"), allege that defendants BASF Corporation, Daiichi Pharmaceutical Co., Ltd., Eisai Co. Ltd., Aventis Animal Nutrition S.A. (formerly known as Poulenc Animal Nutrition S.A.), Hoffmann-La Roche Inc., The Vitamins Inc., and Takeda Chemical Industries Ltd. (the "Settling Defendants") and certain related entities have, among other things, unlawfully conspired to fix, raise, maintain, or stabilize the prices of, and allocate volumes, markets or customers for, certain vitamin products, and that such conduct violated the antitrust and/or consumer protection laws of the Settling States and injured the Settlement Classes. The Settling Defendants deny any liability.

WHAT ARE INDIRECT VITAMIN PRODUCTS?

Indirect Vitamin Products include (a) vitamin A, astaxanthin, vitamin B1 (thiamin), vitamin B2 (riboflavin), vitamin B4 (choline chloride), vitamin B5 (calcium), vitamin B6, vitamin B9 (folic acid), vitamin B12 (cyanocobalamin), beta-carotene, carotenoids, vitamin C, canthaxanthin, vitamin E, and vitamin H (biotin); (b) products containing, or constituted of (in whole or in part), any of the foregoing, including blends and premixes; and (c) products derived from animals that consumed any of the foregoing. Indirect Vitamin Products do not include bulk vitamins or premixes purchased directly from certain manufacturers.

WHO IS IN THE SETTLEMENT CLASSES?

The Settlement Classes include a Consumer Settlement Class defined as all natural persons (excluding the Released Parties) who purchased Indirect Vitamin Products for use or consumption by themselves and/or others and not for resale in any form, and who: (i) are residents of one or more of the Settling States as of October 10, 2000; and (ii) purchased Indirect Vitamin Products from within one or more of the Settling States at any time during the Relevant Period. You need not take any action to remain in the Consumer Settlement Class and you will be represented by Class Counsel and the State Attorneys General. The Consumer Settlement Class will be distributed by check to charitable organizations and other eligible entities.

The Settlement Classes also include a Commercial Settlement Class for each Settling State except Hawaii. The Commercial Settlement Class includes all persons or entities (excluding government entities and the Settling Defendants) who, during the

Relevant Period, made any purchase of Indirect Vitamin Products for resale, for incorporation into another product for resale, or for use in the manufacture, processing, or development of another product (including the feeding of an animal) for resale, where such purchase was (a) made by a buyer in one or more of the Settling States; (b) made from a seller in one or more of the Settling States; or (c) delivered by or on behalf of the seller to the buyer in one or more of the Settling States if the buyer's principal place of business was in one of the Settling States; provided that the purchase did not include bulk vitamins or premixes purchased directly from certain manufacturers; and further provided that such purchase was not a "California Purchase" as that term is defined in the Settlement Agreement. Such California Purchases are the subject of similar class action litigation in California. You may obtain information relating to the California litigation by calling 415-956-1253.

You need not take any action to remain in the Commercial Settlement Class and your rights under the Settlement Agreement will be represented by Class Counsel. If you wish to file a claim against the Commercial Settlement Fund, you must submit a claim form so that it is received by the Settlement Administrator on or before January 7, 2002.

If you wish to exclude yourself from the Consumer and/or Commercial Settlement Classes, you must submit a request for exclusion so that it is received by the Settlement Administrator on or before December 7, 2001, even if you have filed your own lawsuit.

WHAT ARE THE PROPOSED SETTLEMENT TERMS?

In exchange for the release of the claims of the Settlement Classes, the Settling Defendants have agreed to pay up to \$225,250,000.00 (the "Settlement Amount") for the benefit of consumers and businesses in the Settling States.

If you choose to remain in either or both of the Settlement Classes you may, but are not required to, appear in person at the settlement fairness hearings and/or submit comments regarding the fairness, adequacy, and reasonableness of the proposed settlements.

If the settlements are finally approved by the courts, the judgments entered will bind all persons and/or entities in the Settlement Classes who do not timely and properly exclude themselves, and their claims against the Settling Defendants and related entities shall be forever released and dismissed. You are urged to obtain more information as described below in order to preserve your rights.

HOW CAN I OBTAIN ADDITIONAL INFORMATION?

You may obtain additional information concerning the proposed settlements (including hearing dates, claim forms, and requests for exclusion) by (a) writing to the Settlement Administrator: Indirect Vitamin Antitrust Litigation, P.O. Box 8809, Melville, NY 11747-8809; (b) by calling 1-800-424-6662; or (c) visiting the internet web site located at www.vitaminlitigation.com.

You may direct any other questions you may have concerning the Settlement Agreement or this Summary Notice to either Plaintiffs' Lead Counsel: David Boies III, Straus & Boies, LLP, 10513 Braddock Road, Fairfax, Virginia 22032 or Liaison Counsel for the State Attorneys General: Kathleen Harris, Deputy Chief, Antitrust Bureau, Office of the Attorney General of the State of New York, 120 Broadway, New York, New York 10271.

SECRETS OF THE TRULY SHAMELESS



BY ROBERT BARKER

rb@businessweek.com

Thomas Usher promises USX shareholders that he will do half as much work for twice as much money. Will they go for it?

Long ago, a buddy told me I lacked chutzpah. There was no denying it. Yet even as I began marching down the far slope of middle age, I never relinquished dreams of self-improvement. A good thing, because the other day I stumbled upon the perfect role model to help boost my chutzpah quotient. He is Thomas Usher.

If the name rings no bell, it may be only that he works far from such centers of nerviness as Wall Street, Hollywood, or Silicon Valley. Usher is CEO of USX, the Pittsburgh parent of U.S. Steel and Marathon Oil. He aims by yearend to recast the steel and oil units as separate, independent companies. Shareholders are tentatively set to vote on the plan on Oct. 16. USX declined to have Usher or his fellow directors go over it with me. Luckily, a preliminary proxy statement gives plenty of details, enough for me to have been able to distill these Seven Habits of Truly Shameless People:

1. Halve the work, double your pay. Usher is set to keep running U.S. Steel but serve Marathon only as nonexecutive chairman and head of a panel overseeing a joint venture. Last year, his salary and bonus came to \$3.8 million. Next year, Usher is in line for a minimum of \$7.2 million, as USX's board has voted to give him a \$6 million "separation completion bonus," among other rewards (table).

2. Get more, and more. Despite his limited role at Marathon, Usher stands to gain 500,000 Marathon stock-appreciation rights. These work like options. In August, Usher already got a special grant of restricted Marathon stock worth \$2.9 million.

3. Context and timing are everything. For the truly shameless, making out so splendidly works best amid bear markets, looming recessions, and nationwide droughts of bonuses for lower-level executives. Real chutzpah? That is announcing, as Usher did just one week after getting his \$2.9 million in stock, that USX will close its Fairless Works steel and tin mills near Philadelphia, ending 600 jobs. "This is a sad day for U.S. Steel," Usher said in a press release.

4. Use discretion. Ironically, being discreet can be the better part of shamelessness. It yells "of course" to the boldest, most galling move. USX's

proxy shows such quiet insouciance by tucking first mention of Usher's \$6 million payday between parentheses, this way: "(including a completion and retention agreement with the chairman of the board of directors of USX that, among other things, includes a \$6 million bonus)."

5. Know that history is bunk. Pay no mind to discouraging record, such as the laggardly sharing of Marathon's tracking stock since Usher came CEO in 1995 or the negative 27% total return on U.S. Steel's. Rest instead on assertions as this one in the proxy: "The board of directors determined that Mr. Usher's experience and talents will bring value to the groups of stockholders."

6. Don't stop thinking about tomorrow.

future always holds the promise that what's good for you today will somehow, also be good for those who serve. So, focus them forward. As Minow, founder of the Corporate Library, a Web site devoted to research on corporate governance, reminded "shareholder value" was a key reason

USX in 1991 took the unusual course of issuing its tracking stocks while maintaining one company. USX believes that "the businesses of the Marathon Group and the U.S. Steel Group will improve, stockholder value will therefore increase" if they split.

7. Remember friends. Usher, one, however shameless as an island. Not even a man who needs directors to along with his plans. Usher's board of directors includes a five-member compensation committee, which is chaired by US Air Group's former CEO,

Schofield. Schofield, plus two more compensation committee members, Verne Communications Co-CEO Charles and Phelps Dodge Chairman Eme Douglas Yearley, are set to join the U.S. Steel and Marathon boards. They, along with a fourth USX director named to both boards, Richard Polytechnic Institute President

Shirley Ann Jackson, will see their compensation as directors double.

With all this in mind, I have resolved to do more chutzpah on the job. I'm thinking, may be big bonus plus lots of stock and options (even I cut back to writing half as many columns). course, my future work will be twice as good. That's a deal you would vote for, wouldn't you?



Divide and Cash in

If USX completes its split into two independent companies, U.S. Steel and Marathon Oil, CEO Thomas Usher can look forward to a rich reward.

(IN THOUSANDS)	2000	2002
SALARY	\$1,325	\$1,185
REGULAR BONUS	2,500	NA*
SEPARATION COMPLETION BONUS		6,000
RETENTION BONUS		3,000**

*Not available; amount, from zero to \$3 million, to be set by board of directors; **Payable, subject to performance goals, on third anniversary of split
Data: Company reports



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breakthrough

The technological advances of the past few decades have fundamentally transformed the ways corporate executives make decisions and lead their companies. Today's corporation demands a new breed of leader—one who keeps a careful eye on the big picture, keeps abreast of new developments, and embraces and initiates change rather than reacting to the innovations of others.

Knowledge is the keystone of such a leadership style. The inaugural edition of *Breakthrough: Corporate Leadership Summit*, held June 27–29 in San Diego, California, was designed to provide this knowledge through discussions between top executives and renowned technologists, scientists, and creative thinkers. Presentations and discussions were organized around five themes:

- **The Changing Rules of Leadership, the Evolving Qualities of Leaders:** What personal qualities are essential for leaders in an increasingly technological business environment?
- **Continuous Supply-chain Funding and Precision Demand Forecasting:** How are New Economy tools changing the information flow in businesses today?
- **Globalization, Technology, and the "Trusted Identity":** How can senior executives establish their companies as trusted players in the global e-commerce marketplace?
- **Pervasive Computing and the Proliferation of Wireless Technologies:** Computing power will soon be everywhere. How should leaders manage this new environment?
- **Customer Ascendancy:** How can leaders change their business models to accommodate customers' changing needs and expectations?

THE CHANGING RULES OF LEADERSHIP, THE EVOLVING QUALITIES OF LEADERS
Today's leaders frequently find themselves on the cutting edge of change, with no established wisdom to guide their decisions. According to Dr. Ronald Heifetz, codirector of the Center for Public Leadership at the John F. Kennedy School of Government at Harvard University and author of *Leadership Without Easy Answers*, the temptation in this situation is to treat problems as *technical* rather than *adaptive* challenges. What's the difference? "Technical challenges are those to which responses already exist. We have the know-how, the procedures, and the expertise to solve them," explains Heifetz. "Adaptive challenges, on the other hand, are those in which people have to learn new ways. To respond, you have to go from chief decision-maker to chief educator." Ingrained attitudes, however, can make it difficult for leaders to address adaptive challenges. Why? "When you're facing an adaptive challenge, the truth is you don't know how to proceed," says Heifetz.

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KRIS HIRSHMANN

"YOUR JOB AS A LEADER ISN'T TO
KEEP PEOPLE HAPPY. IT IS TO GENERATE
DISEQUILIBRIUM AND KEEP THEM
PRODUCTIVELY UNCOMFORTABLE."

—Dr. Ronald A. Heifetz, codirector of the
Center for Public Leadership, John F. Kennedy School
of Government, Harvard University



Dr. Ronald A. Heifetz addresses a question from the audience.

"ALL OF OUR SUPPLY CHAINS
ARE NOW TIED TOGETHER WITH
REAL-TIME INFORMATION. ALL OF OUR
CUSTOMERS THINK GLOBALLY NOW."

—William D. Zollars, chairman, president, and CEO,
Yellow Corporation

"PERVASIVE COMPUTING
APPLICATIONS DON'T HAVE TO BE
COMPLEX. SIMPLE APPLICATIONS
WILL PROBABLY DRIVE THE
PERVASIVE COMPUTING GRID."

—Michel Mayer, general manager,
IBM Pervasive Computing

"When people expect you to solve their problems competently, but instead you're working in an adaptive context where your job is to mobilize discovery, people will feel let down. So it's essential to educate your people to know the difference between technical and adaptive work."

This principle may be especially important in the scientific arena, where life on the cutting edge is the norm. J. Craig Venter, president and chief scientific officer of Celera Genomics, has ample experience with discovery management as an aspect of leadership. On the one hand, says Venter, managing is managing: "Scientists as leaders need a management skill set no matter where they work. You still have to manage hundreds of people." On the other hand, employees are hired because they have highly specific knowledge and skills, and they must be free to apply those abilities as they see best. How does Venter handle this management challenge? "I don't micromanage. I set goals, then hire top people and turn them loose to do the job. They're very motivated because everybody knows that if their process fails, the entire process fails. It's a team effort. I may be the orchestra conductor, but if a single part doesn't work, then neither does the overall effort."

CONTINUOUS SUPPLY-CHAIN FUNDING AND PRECISION DEMAND FORECASTING

Another primary concern for today's leaders is the evaluation and implementation of new technologies and processes. This transition is a particular challenge for old-line businesses with long-established systems and culture. But the results make the pain worthwhile, says William Zollars, chairman, president, and CEO of Yellow Corporation, who explains how supply-chain management tools have changed his company.

"The old Yellow was big and slow. We knew what technology was, but we weren't using it to help us drive solutions in our business.... Today we are technology driven. We're still big, but we're nimble and flexible."

Supply-chain management is a major part of Yellow's newfound flexibility.

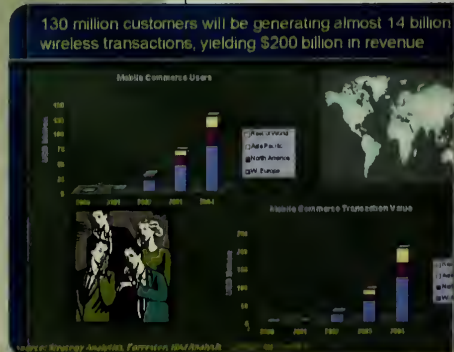
Zollars offers an example: "In the old days, if we had an economic slowdown like we've had over the past year, it would have taken time for inventory to be adjusted and the end result would have been an impact on us, because we're the people who move the goods. But because supply chains are so interlocked today and because technology is so good, it hit us as soon

PERVASIVE COMPUTING AND THE PROLIFERATION OF WIRELESS TECHNOLOGIES

Mobile and wireless services are exploding across the world, sowing the seeds of a "pervasive computing" environment—one in which information and services are available anywhere, anytime, at the touch of a button. The business implications are tremendous: "By 2004, 130 million customers will be generating almost 14 billion wireless transactions per year, yielding \$200 billion in revenue. Mobile-enabled employee, customer, and business partner processes will drive significant operational performance, and location-based services will drive increased customer satisfaction and loyalty," says Michael Shank, director of IBM Global Services' Strategy and Change Consulting.

Business leaders are eager to grab their share of the pie. But setting a strategy first is essential, says Shank. "With a combination of strategy and technology, we can do just about anything—but you can't do everything. You have to choose. Strategy is as much about what you're not going to do as what you are going to do. You must understand how pervasive computing technology impacts your industry and business model before you can determine where to place your initial emphasis or identify your strategic initiatives."

That task will only get more complex as pervasive computing spreads beyond wireless. As Michel Mayer, general manager of IBM's pervasive computing division, explains, "Mobile and wireless Internet access are only a small part of the overall phenomenon. Pervasive computing will be about communication, storage, and processing capabilities going into objects that we do not associate today with computers—things like tools, clothes, jewelry. Everything will eventually have some element of computing capability."



people stopped buying stuff. It was a zero-response-time reaction." Such abilities, says [illegible], are not just desirable, they are essential: "Everything is time-definite today, real-time information is mandatory."

GLOBALIZATION, TECHNOLOGY, AND THE TRUSTED IDENTITY

The global finance community is also struggling to find its footing in the New Economy. Traditional paper-based transaction methods are increasingly impractical in an interconnected business world where pervasive computing is becoming the norm. (See sidebar entitled *Pervasive Computing and the Proliferation of Wireless Technologies* for more information on this subject, which was the topic of a separate Breakthrough session.) This discontinuity has given rise to the concept of the "trusted identity"—third-party electronic certification of a business's identity, resources, and financial history. "Trust is a fundamental underpinning of business-to-business e-commerce, and it must be embodied in the new exchange mechanisms that we use in the future," explains Guy Tallent, president and CEO of Identrus, a company that provides such certification.

While companies like Identrus are building trust into the e-commerce transaction platform, others are reinforcing it with complementary services. Avantrust, a joint venture of insurer AIG and [illegible] & Bradstreet, is one such company. "We identified four basic questions in online transactions. Who am I trading with and how can I be sure of that? Will I get paid and what happens if I don't? Will the right goods arrive in good condition? And is the site secure from hacking and downtime?" says Gretchen Hayes, president of AIG eBusiness Risk Solutions. "Our mission is to develop, design, and then underwrite insurance solutions to address these risks. So far we've launched an identity insurance product, an online real-time credit monitoring product, and a network security product."

CUSTOMER ASCENDANCY

Trust is also the key to customer care, an ever-more-important aspect of business in the information age. The most successful businesses, in fact, are those that have learned to treat customers as valued members of the corporate team. Susanne Lyons, chief marketing officer for Charles Schwab & Co., Inc., explains the value of this approach: "Clients tell you what they like and what they don't like. If you listen, you can do something with that information." It sounds easy—but it's not. Listening alone, Lyons admits, will not yield results. "It's not enough just to capture data and information. You have to turn it into wisdom about your clients and

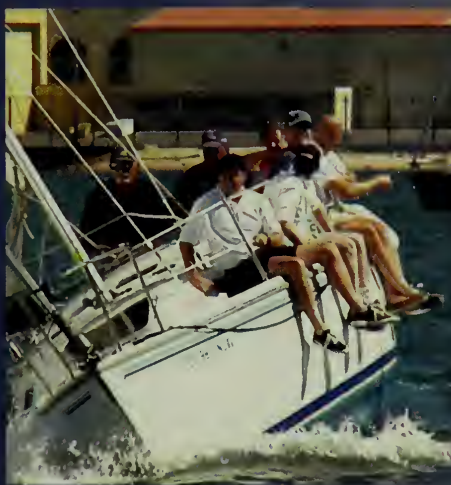
THE BREAKTHROUGH REGATTA

Teamwork and competition are bywords in today's corporation. Conference attendees came face-to-face with their attitudes toward these concepts during a three-hour sailing regatta in San Diego Harbor. Executives were split into ten teams. One lucky team was under the command of Dennis Conner, the four-time America's Cup champion; the others were each under the command of a member of Conner's "Stars and Stripes" crew. The teams engaged in an exhilarating race that doubled as an exploration of the new realities of leadership, competition, and teamwork in the New Economy.

Following the regatta, Conner shared some tips for motivating a team. "I don't consciously give pep talks," he says. "I prefer to lead by example. My crew sees my hard work and dedication, and they see that I have covered all the bases. I do my own homework and I try to make sure my crew believes that they're ready by virtue of being the best they can be. When people go into an event with that type of feeling, they generally have no excuse to lose. It's a matter of doing what you can to keep your head in the game, to keep trying, and to give yourself a chance to win if you get a good break."

Right: Dennis Conner (second from left), and conference delegates racing for the finish line!

Below right: An exciting start as the boats take off and participants begin their exploratory journey of leadership, competition, and teamwork.



"IN E-COMMERCE, IT IS ESSENTIAL TO DETERMINE WHO YOUR TRADING PARTNERS ARE AND TO VERIFY THAT THEY ARE AUTHORIZED TO MAKE CERTAIN TRANSACTIONS."

—Gretchen Hayes, president,
AIG eBusiness Risk Solutions

"TRUST IS THE GIFT THAT NEVER STOPS GIVING IN YOUR RELATIONSHIP WITH CUSTOMERS."

—Jim Taylor, conference chairman and co-author of *The Visionary's Handbook* and *The 500-Year Delta*

and begin to understand what particular offers or services might be of value to any given one of them. And doing this is not only good for your customer relationships, helps you to make sure that your business is evolving the way it needs to."

Understanding customers has another benefit. It engenders trust, thereby building loyalty and long-term associations. In the words of Jim Taylor, conference chairman and co-author of *The Visionary's Handbook* and *The 500-Year Delta*, "Trust is the gift that never stops giving in your relationship with customers." But this game must be played

carefully. Once earned, customers' trust must be held sacred, says Taylor: "Violations of trust are betrayals, and the anger that arises from trust violations is righteous indignation. When we violate the presumptions of customers, they respond with the kind of indignation that leads not just to lawsuits but to public broadcasting about our inadequacy."

THE NEW ECONOMY DOWNTURN: HOW IS IT DIFFERENT, WHERE IS IT GOING?

Despite the current downturn, Michael Mandel, BusinessWeek economics editor, remains bullish about technology. "My long-term vision of the economy is extremely positive. Driven by technology and innovation, the U.S. economy will be able to achieve very high levels of growth." However, he says, businesses had better get used to economic downturns. From now on, they will be a fact of life. Why? "Every economy has a driving force. In the New Economy, those forces are technology, innovation, and venture capital. Unfortunately these are extremely volatile sectors of the economy, which means that ups and downs are going to be a feature of the New Economy. You have to understand that this is the new norm. It's inevitable, and you have to prepare for it."

What caused the current economic slump? According to Margaret Popper, BusinessWeek Online's "Street Wise" columnist, "People took a perfectly reasonable bet on unproven technology. As it turned out, most of the bets didn't pan out." But like Mandel, Popper remains optimistic: "Does that mean there's no value in the tech sector? Should we scrap the entire idea of technology and its importance to the new economy? Absolutely not."

IT'S STILL ABOUT PEOPLE

Questions of trust and loyalty may seem out of place in a discussion of information technology. But in truth, they are one of the core issues facing businesses today. In the race for technological advancement, it can be easy for leaders to become focused on processes rather than people. Employees in particular need nurturing if they are to grow to their full potential within a company, says Deepak Chopra, founder and CEO of the Chopra Center for Well Being: "The leader to empower the followers into their own unique ability to express their skills. True leadership from the level of the spirit engenders in those who are part of the team the ability to be independent, ultimately, of your leadership."

A leader who encourages independence in this manner may be surprised to find that the result is tangible. According to Stephen Vetter, president of Eureka Communities, there is a clear connection between personal power and corporate wealth. "Wealth begins with one individual who can produce something of value. That's intellectual capital. If that one person combines with a few others, they create social capital. And

when these two forms of capital are in place, then and only then will you get to operating investment capital," explains Vetter. In a competitive environment of dizzying complexity where decision-making is increasingly enabled by technology, perhaps it is reassuring that effective leadership still, in the end, boils down to the people.

To view a Web cast of **Breakthrough: Corporate Leadership Summit**, visit our Web site at www.conferences.businessweek.com



BusinessWeek editors from left to right: Michael Mandel, Chris Palmeri, Lee Walczak, and Margaret Popper.

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SPIN-OFF AT TITAN?



GENE G. MARCIAL

It could take
public its thriving
defense arm. Web
collaboration from
Centra may bloom,
travel withers.
CompuDyne sees
spike in demand
security gear

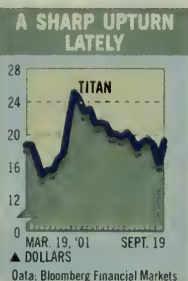
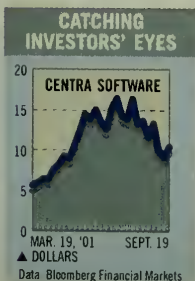
Big Board-listed Titan (TTN), a conglomerate operating in five businesses, was among the handful of stocks that bucked the tumble on Sept. 17—the day the market reopened. The reason: One of its units, Titan Systems, provides information technology for defense, intelligence, and other federal agencies.

The stock bumped up 2.33, to 18.58 that day, but other pure-play defense stocks did much better, rising by 20% to 50%. Money manager Michael Lauer of hedge fund Lancer Group, which owns a nearly 5% stake, thinks the company deserves a higher price—because it's more than just a defense play. Titan, he says, may be poised to spin off and take public its defense operations, which are expected to account for 78% of 2001's estimated revenues of \$1.16 billion. Lauer figures the defense business alone is worth 30 a share. So on a sum-of-the-parts basis, Titan is worth 48, argues Lauer. Titan's defense operation would—as a separate company—get a higher valuation because of its profitability and growth potential. He says management is under pressure to do the spin-off, lest Titan become takeover prey.

Here's how he values Titan's other operations: Its SureBeam unit, which makes pasteurization systems, is worth 7 a share; Emerging Technologies, an incubator of new tech systems for commercial uses, 6; Titan Wireless, a telecom infrastructure provider to developing nations, 3; and Cayenta, which tailors software applications for specific Web requirements, 2. Phua Young of Merrill Lynch, who rates Titan a buy, sees earnings of 32¢ a share in 2001 and 83¢ in 2002.

HOW CENTRA KEEPS YOU OUT OF AIRPORTS

A new buzzword is “Web collaboration,” which means corporations doing business internally or with each other on the Internet—for meetings, seminars, staff training, or marketing. Market leader Centra Software (CTRA) has caught investors' eyes in the wake of the terrorist attacks. Analyst Trace Urdan of W.R. Hambrecht expects demand for its Web-based communication products to shoot up because of curtailed business air travel, in the wake of the Sept. 11 hijackings. Urdan says heightened security combined with a reluctance by many to resume normal travel will swell demand for Centra's products.



Centra Software stock jumped 1.95, to 10.95, on Sept. 17, and ran up some more the next day, to 12.15. It closed at 10.60 on Sept. 19. Urdan, who rates the stock a buy, values the stock at 20, based on his assumption that Centra will turn profitable in 2002, earning an estimated 25¢ a share on sales of \$76.7 million, vs. an estimated loss of 38¢ on sales of \$46.3 million in 2001. Founder and CEO Leon Navickas says Centra will beat estimates this year and next in spite of the economic downturn.

Centra's big clients include Switzerland's Novartis, Japan's Nippon Telegraph & Telephone and Sony, and Brazil Telecom. Its marketing partners in the U.S. include Microsoft and Price-waterhouseCoopers.

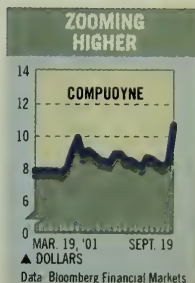
BEEFED-UP SECURITY FROM COMPU DYNE

Nobody on Wall Street follows CompuDyne (CDCY)—yet. But analyst coverage may come soon: In just two days, the stock zoomed from 8.25 to 12.40. It ended at 10.05 on Sept. 19. “Even at that price, the stock still looks reasonably priced,” says Jim Macdonald of First Analysis in Chicago, who follows the security-equipment industry. Bullet- and blast-proof doors and windows are CompuDyne's specialty, hence the stock's sharp rise on Sept. 17, when the market reopened.

CompuDyne, which is upgrading the doors and windows of U.S. embassies in 50 countries, is the outfit the White House and the Federal Reserve call to make sure their doors and windows can withstand assaults.

“Sales of the high-margin, blast-resistant products should grow from \$20 million to \$30 million or \$35 million in two years,” estimates CEO Martin Roenigk. CompuDyne also supplies security and specialty engineering and telecom products to the military and intelligence agencies, electronic security products for prisons, and all-steel jailhouses.

CompuDyne recently acquired Tiburon, a developer of 911-software for police, firefighters, and medical emergency people. Its products are being used in the rescue efforts at the World Trade Center, says Roenigk. He expects overall revenues to jump from \$130 million in 2000 to \$135 million in 2001 and to \$200 million in 2002. He sees earnings of 70¢ to 72¢ a share in 2001 and 84¢ to 86¢ in 2002, up from 2000's 60¢.



BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:10 p.m. EST on CNN's *The Money Gang*.

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BusinessWeek's **Rethinking the Internet** will examine the firms that are using the Internet to improve business processes, boost sales, enhance relationships, shrink costs, and manage business through the economic downturn. The conference will provide a frank assessment of the Internet economy in the wake of the dot-com meltdown, offering insight into the technologies and e.biz practices that are likely to emerge from the wreckage.

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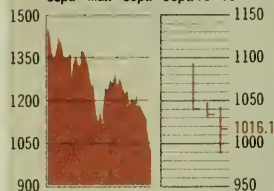
Yoram (Jerry) Wind

Lauder Professor of Marketing; Director, SEI Center
for Advanced Studies in Management and Wharton
Fellows Program, University of Pennsylvania

Stocks

S&P 500

Sept. Mar. Sept. Sept. 13-19



COMMENTARY

After a four-day hiatus following Sept. 11's terrorist attacks on New York's World Trade Center, the market fell sharply this week. In just three days the Dow lost 8.8%, doubling losses already suffered in this earnings-challenged year. Schwab, Kodak and others weakened after cutting profit forecasts, while broad sectors, such as insurance and brokerages, felt the brunt of the sell-off.

Data: Bloomberg Financial Markets
Bridge Information Systems, Inc.

U.S. MARKETS

	Sept. 19	Week	Year to date	Last 12 months
S&P 500	1016.1	-7.0	-23.0	-30.4
Dow Jones Industrials	8759.1	-8.8	-18.8	-18.8
Nasdaq Composite	1527.8	-9.9	-38.2	-60.5
S&P MidCap 400	428.8	-8.2	-17.0	-19.3
S&P SmallCap 600	191.3	-9.0	-12.9	-12.2
Wilshire 5000	9357.8	-7.4	-23.1	-31.9

SECTORS

	Sept. 19	Week	Year to date	Last 12 months
BusinessWeek 50*	679.4	-6.3	-30.0	-44.8
BusinessWeek Info Tech 100**	337.6	-3.5	-40.3	-63.4
S&P/BARRA Growth	517.0	-6.2	-24.8	-40.2
S&P/BARRA Value	499.1	-7.9	-21.5	-19.4
S&P Energy	773.6	-9.2	-17.0	-17.2
S&P Financials	129.3	-7.0	-21.5	-17.7
S&P REIT	89.3	-3.5	1.5	4.3
S&P Transportation	542.8	-17.0	-22.2	-6.5
S&P Utilities	257.2	-6.4	-26.7	-20.3
GSTI Internet	78.0	-10.9	-57.0	-82.8
PSE Technology	529.2	-9.7	-35.0	-51.5

*Mar. 19, 1999 = 1000 **Feb. 7, 2000 = 1000

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Defense Electronics	20.4	Tobacco 75.5
Metal & Glass Containers	11.7	Engineering & Constr. 71.7
Tobacco	8.4	Savings & Loans 45.4
Soft Drinks	5.7	Toys 40.8
Gold Mining	3.6	Pollution Control 36.9

GLOBAL MARKETS

	Sept. 19	Week	Year to date
S&P Euro Plus (U.S. Dollar)	933.2	-2.7	-3.0
London (FT-SE 100)	4721.7	-3.3	-2.0
Paris (CAC 40)	3888.9	-5.5	-3.0
Frankfurt (DAX)	4041.8	-6.8	-3.0
Tokyo (NIKKEI 225)	9939.6	3.4	-2.0
Hong Kong (Hang Seng)	9558.2	0.7	-1.0
Toronto (TSE 300)	6696.3	-5.0	-2.0
Mexico City (IPC)	5256.0	-5.0	-2.0

FUNDAMENTALS

	Sept. 18	Wk. ago
S&P 500 Dividend Yield	1.50%	1.42
S&P 500 P/E Ratio (Trailing 12 mos.)	28.5	30.1
S&P 500 P/E Ratio (Next 12 mos.)*	18.6	19.5
First Call Earnings Revision*	-2.43%	-2.45

*First Call Corp.

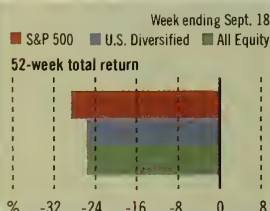
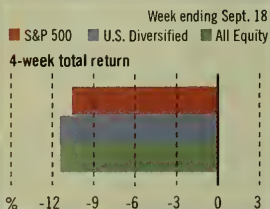
TECHNICAL INDICATORS

	Sept. 18	Wk. ago
S&P 500 200-day average	1243.4	1246.4
Stocks above 200-day average	38.0%	51.0
Options: Put/call ratio	0.96	0.89
Insiders: Vickers Sell/buy ratio	2.73	2.57

WORST-PERFORMING GROUPS

	Last month %	Last 12 months %
Hotels & Motels	-36.2	Communications Eq. 1.42
Airlines	-33.7	Semiconductors 30.1
Specialty Appar. Retailers	-32.8	Computer Systems 19.5
Personal Loans	-29.2	Oil & Gas Drilling 2.45
Entertainment	-25.6	Instrumentation 2.57

Mutual Funds



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-week total return	%	52-week total return	%
Leaders		Leaders	
Precious Metals	2.1	Precious Metals	19.2
Utilities	-4.3	Real Estate	8.2
International Hybrid	-5.6	Small-cap Value	3.9
Domestic Hybrid	-6.3	Mid-cap Value	3.1
Laggards		Laggards	
Technology	-17.4	Technology	-63.3
Pacific/Asia ex-Japan	-16.7	Communications	-58.6
Latin America	-15.2	Japan	-45.2
Diversified Pacific/Asia	-14.3	Mid-cap Growth	-44.0

EQUITY FUNDS

4-week total return	%	52-week total return	%
Leaders		Leaders	
ProFunds UltraShort OTC	40.4	Potomac Internet Short	277.7
Rydex Dynamic Vent. 100	40.1	Rydex Dynamic Vent. 100	246.1
Prudent Bear	24.6	ProFunds UltraShort OTC	231.6
Rydex Dynamic Temp. 500	24.1	ProFunds UltraBear Inv.	89.5
Laggards		Laggards	
ProFunds UltraOTC Inv.	-33.1	ProFunds UltraOTC Inv.	-93.2
Rydex Leisure Inv.	-27.2	Jacob Internet	-87.0
Frontier Equity	-26.9	Potomac Internet Plus	-86.8
Fidelity Sel. Air Transport	-25.8	ING Internet A	-84.8

Interest Rates

KEY RATES

	Sept. 19	Week ago
MONEY MARKET FUNDS	3.22%	3.27%
90-DAY TREASURY BILLS	2.19	3.26
1-YEAR TREASURY BILLS	2.69	3.31
10-YEAR TREASURY NOTES	4.69	4.84
30-YEAR TREASURY BONDS	5.55	5.43
30-YEAR FIXED MORTGAGE	6.72	6.89

†BanxQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 31% federal tax rate.

	10-yr. bond
GENERAL OBLIGATIONS	4.08%
TAXABLE EQUIVALENT	5.91
INSURED REVENUE BONDS	4.21
TAXABLE EQUIVALENT	6.10

THE WEEK AHEAD

LEADING INDICATORS Monday, Sept. 24, 10 a.m. EDT ▶ The Conference Board's composite index of leading indicators probably remained unchanged in August. That's according to the median forecast of economists surveyed by Standard & Poor's MMS, a division of The McGraw-Hill Companies.

CONSUMER CONFIDENCE Tuesday, Sept. 25, 10 a.m. EDT ▶ The Conference Board's consumer confidence index for September likely tumbled to 105.5, from 114.3

in August. The forecasted drop is in response to the terrorist attacks and now-uncertain economic future.

EXISTING HOME SALES Tuesday, Sept. 25, 10 a.m. EDT ▶ Sales of existing homes likely rose to an annual rate of 5.2 million in August, from 5.17 million in July.

DURABLE GOODS ORDERS Thursday, Sept. 27, 8:30 a.m. EDT ▶ New orders for durable goods probably fell 1% in August, after declining 0.6% in July.

NEW RESIDENTIAL SALES Thursday, Sept. 27, 10 a.m. EDT ▶ New single-family sales in August likely dropped to annual rate of 920,000.

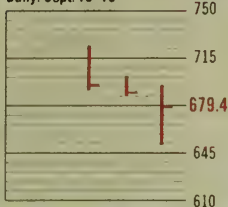
GROSS DOMESTIC PRODUCT (FINAL) Friday, Sept. 28, 8:30 a.m. EDT ▶ The Commerce Dept.'s final look at the second quarter economy is projected to show real GDP grew at an annual rate of 0.5%, unchanged from the preliminary estimate. Third-quarter real GDP is expected to fall 0.5%, the first time since

BusinessWeek Fifty

Mar.

Sept.

Daily: Sept. 13-19



Weekly

all 6.3%, faring better than the overall market. All the same, many stocks had double-digit loss-
sly in the financial and technology sectors. Micron Technology, the worst performer by far, fell 26.2%.
d 21.4%. Provident Financial, already battered by analysts, lost 21.3%. Only three issues ended
sure-shortened week: Washington Mutual, General Dynamics, and Verizon Communications.

COMPANY PERFORMANCE

Company	% change		Rank	Company	% change	
	Week	Since 3/1/01			Week	Since 3/1/01
International	-8.3	-19.9	26	Verizon Communications	6.3	11.3
Petroleum	-12.1	-26.0	27	Citigroup	-9.4	-21.0
	-15.7	-45.0	28	Sun Microsystems	-11.6	-54.6
	-14.0	-27.9	29	Merck	2.7	-14.9
Materials	-22.3	-31.3	30	El Paso	-10.4	-36.9
Financial	-21.3	-58.1	31	Altera	-21.4	-18.8
Petroleum	-11.9	3.3	32	Marsh & McLennan	-5.2	-21.8
	-13.0	-29.4	33	Household International	-7.1	-10.4
lee	-12.3	-19.1	34	Chevron	-7.4	-2.2
	-2.3	-47.6	35	SBC Communications	0.0	-4.5
Brothers Holdings	-17.3	-24.8	36	Mercury Interactive	-13.1	-64.8
	-9.7	-70.6	37	AOL Time Warner	-10.1	-29.7
	-20.1	-57.6	38	Washington Mutual	7.3	11.6
laboratories	-8.8	1.1	39	General Dynamics	9.0	23.4
ton Financial	-1.1	-15.7	40	Comcast	-1.5	-21.8
chnology	-26.2	-34.7	41	Morgan Stanley Dean Witter	-14.1	-34.0
	-19.9	-29.8	42	Tellabs	-2.4	-75.3
Hess	-9.7	-4.1	43	Exxon Mobil	-6.9	-5.6
rgy	-4.1	-8.4	44	Scientific-Atlanta	1.0	-61.4
communications	-11.0	-72.1	45	U.S. Bancorp	-9.4	-7.5
ne Financial	-20.4	-28.2	46	Paychex	-0.4	-20.3
etroleum	0.0	9.5	47	Merrill Lynch	-17.8	-35.8
evices	-19.1	-17.7	48	Bed Bath & Beyond	-10.9	-13.4
urces	-14.2	-35.6	49	Texas Instruments	-16.5	-26.2
Health	-0.7	4.2	50	Teradyne	-15.6	-22.2

Production Index

Change from last week: -0.4%
Change from last year: -6.0%

RIAL OUTPUT Sept. 8=166.0 1992=100



n index was once again lower during the
efore calculation of the four-week moving
index declined to 165.1, from 165.9. On a
usted basis, the index was dragged low-
eclines in coal, rail-freight traffic, and
steel was down slightly. Autos were high-
on levels held steady despite the short-
y work week. Trucks, electric power, and
ing were also higher.

ch of the index components is at www.business-week.com
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We at Williams Communications offer
our deepest sympathies to those affected
by the tragedies of September 11.

We would also like to offer our
support to the brave men and women
involved in the recovery efforts.

What was meant to bring our
great nation down, has only brought us
closer together.



WHAT TERRORISM MEANS FOR THE ECONOMY

There is no historic precedent for the massive terrorist attack on America and we can't know for sure what all the consequences will be. What we can do is begin to examine how America, and the American economy in particular, will change, for there is little doubt that change is coming. Terrorism introduces a new, systemic risk into society. Dealing with it may result in rethinking the economy that we now take for granted. Defense spending may soon consume a greater share of gross domestic product; the cost of doing business may be going up; productivity gains, in the short run, could become more difficult to generate; and consumer confidence may come to depend more on foreign policy and military success than ever before. To anyone coming of age in the full-employment, entertainment-driven '90s economy, this is all very new and perhaps frightening. It need not be.

The U.S. has recalibrated the balance between private and public sectors, between markets and government intervention, many times. Whenever a national emergency arises, be it war or economic crisis, the scope of government action expands. It is demanded by the people and necessary for the country. This is such a time. A new deal, in effect, between Washington and industry is being negotiated that modifies the roles and relationships between the two. The goal must be to preserve the freedom and vibrancy of the market economy while providing security and confidence to the American people. It's a delicate balance, and there is no room for ideology in it. But we've been there before and prospered.

There may be echoes of the cold war economy in the months ahead, but don't expect a return to the days when defense ate up 7% to 10% of gross domestic product, regulation was heavy, taxes high, and the government intervened with such things as wage and price controls. Here are some early best guesses on how the American economy may change:

Defense will play a bigger role in the economy. Before Sept. 11, defense spending as a share of GDP was down to a record post-World War II low of 3%, vs. 7% in the Reagan years. The peace dividend since the end of the cold war in 1989 was unquestionably important in shifting capital from Washington to the private markets to finance business investment, higher productivity, and the entrepreneurial burst of the New Economy. Yet low defense spending in and of itself is no guarantee of prosperity. The 1960s were a period of high productivity and fast noninflationary growth. Defense spending's share of the economy then was nearly three times as high as today, averaging about 9% of GDP for the decade.

In fact, defense spending on research and development has sparked much innovation. Microchips, radar, lasers, satellite communications, cell phones, GPS, and the Internet all came out of Defense Dept. funding of basic research at the Massachusetts Institute of Technology, Stanford University and national laboratories. There were breakthroughs at IBM and Bell Laboratories, and all were commercialized by Intel Corp., Motorola Inc., and many other corporations. Higher

spending on defense R&D could generate more innovation.

There may be one serious economic penalty to paying for shifting capital back to the federal government: Entrepreneurialism may suffer. The venture-capital/initial public offering/stock market financing machine that gave birth to the tech boom may have fewer resources and less appetite for risky investing in new ventures. This could be a real loss.

The cost of business is going up. The airlines and insurance industry will bear the brunt of the World Trade Center catastrophe. But nearly all corporations will face higher costs for security. Short-term, this means hiring guards, configuring real estate, and improving surveillance systems. Long-term, security concerns will slow the international flow of goods and people. Costs will rise. How much no one knows.

Corporate America and the Bush Administration must decide how to distribute the cost of the new security burden on U.S. business. This is a delicate and critical negotiation with very high stakes. The airlines want a big bailout, with cash infusions, huge loan guarantees, and the government picking up the burden of airport security. Critics argue that bankruptcy is the most efficient way of dealing with the emergency.

Given the need to restore confidence in the economy, it may be necessary for the federal government to step in, as it did with Chrysler, Lockheed, and the savings and loan industry, and help with loan guarantees. Ensuring that some safety net exists for the tens of thousands of employees laid off as a sequence of terrorist attacks may be in order as well. But intervention to save companies should be held to a minimum. It is all too easy to hide home-grown managerial deficiencies, business cycle problems under a security umbrella. Airline, steel, rental cars and other industries are rushing for government aid under the guise of "national security."

Profits will be hit harder and productivity may suffer. Terrorists struck just when corporations were at their most vulnerable, with profits in deep recession. The burden of higher security costs threatens to erode profits for years. This could hurt investment and gains in productivity, with serious repercussions for economic growth and stock market valuations. The virtuous cycle that brought so much prosperity to America and the world in the 1990s could be broken.

But not necessarily. Back in the '60s, President John F. Kennedy passed a large investment tax credit that helped revive corporate capital spending. Productivity growth remained high. Today, faster depreciation schedules, especially for high-tech equipment, could bolster cash flow. An unanticipated government spending plus an unprecedented flood of liquidity unleashed by the Federal Reserve could send growth and corporate profits up sharply by the end of next year.

What is under way is a modest recalibration of public and private economic roles for the government and the market. No more, no less. Americans face a tough year. But we've been there before and prospered.



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OBER 8, 2001

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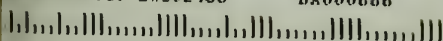
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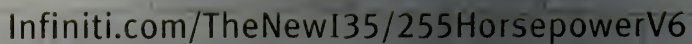
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THE DEAL MILL

AT&T AND BELL SOUTH TALK MERGER

THIS MAY BE THE FINAL ACT for AT&T. *BusinessWeek* has learned that CEO Mike Armstrong has proposed a "merger of equals" with BellSouth. Sources familiar with the deal say AT&T dispatched President David Dorman in mid-September with the offer: AT&T would first spin off its cable-TV unit, then merge its remaining telecom businesses with BellSouth.

CEO Duane Ackerman is interested if the price is right, the sources say.

The value of the deal and who would take over management are up in the air. The talks, code-named "Brazil," could fall apart at any time or another suitor could emerge. But AT&T wants to seal the deal by the end of October, according to the sources. Neither company will comment on the proposal.

After AT&T spins off its cable unit, it will have a market cap of \$30 billion to \$40 billion—compared with BellSouth's \$79 billion. That would make the "merger of equals" Armstrong envisages difficult. AT&T spun off its

wireless unit earlier this year. Comcast is offering \$35 billion for cable, but Armstrong is seeking bids from others such as AOL Time Warner.

The deal with BellSouth would reunite AT&T with a big piece of the old Bell system, which it spun off in a 1984 court-ordered breakup. Former FCC Chairman Reed Hundt said in 1997, when

WHO'LL BE BOSS?
Armstrong, Ackerman



AT&T was considering merging with SBC Communications, that such a deal was "unthinkable." But a lot has changed. The telecom industry is in a deep recession that has eroded AT&T's position. The current FCC

is also more receptive to industry consolidation.

There are obstacles. BellSouth is barred by law from offering long-distance service in its nine-state local-phone territory in the South. AT&T is confident the deal could be approved with conditions. The Telecom Act bars BellSouth from owning large stakes in cable. That's one reason AT&T is keen to sell its unit.

The deal makes strategic sense. Neither BellSouth nor AT&T have the scale to match SBC and Verizon, the strongest players in U.S. telecom. The deal would catapult BellSouth to the forefront of the long-distance pack and—more important—make it a leading presence in services for big businesses.

But merger is no panacea. AT&T has lots of operational problems. Whoever ends up running it will have plenty of work to do. *Steve Rosenbush*

A BELL REUNION?

STRUCTURE After AT&T completes the sale of its cable-TV unit, to Comcast or perhaps to AOL Time Warner, it would combine the remaining telecom units with BellSouth. Price and management to be determined. AT&T wants the deal sealed by end October.

CHALLENGES Regulations limit BellSouth's ability to own cable TV or offer long-distance phone service. So AT&T wants to spin off its cable.

TALK SHOW "If I am killed, one thousand new Osamas replace me."

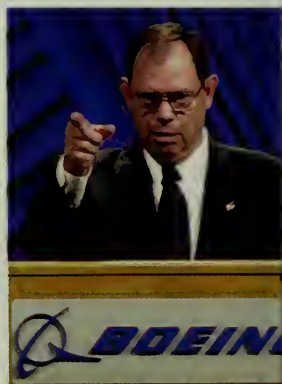
—Osama bin Laden. The name Osama is a favorite name being given to babies in Pakistan.

HONCHOS

PRESSURE IS ON TO SHARE THE PAIN

DONALD CARTY, THE American Airlines CEO who earned \$4.5 million last year, may be on to something. He announced Sept. 24 that he would give up his pay for the remainder of the year—days after laying off 20,000 employees.

The pressure is mounting for others to do the same, compensation experts say. With airlines laying off 110,000 employees in the wake of the Sept. 11 attacks, CEOs like Philip Condit at Boeing and Gordon Bethune at Continental will find calls to take voluntary pay cuts increasing. Condit made \$19.8 million last year, Bethune \$13.7 million. Hardly excessive by CEO standards, but with stock prices plunging, investors as well as labor groups want to see top management share their pain.



CONDIT: Next to be targeted

"Shareholders are going to be expecting that," says Kay, compensation consultant at Watson Wyatt Worldwide.

Tourism and media, with CEOs such as Disney's Michael Eisner made \$72.8 million year, may be next on the list. Notes Patrick McGee, corporate programs director at proxy advisers Institutional Shareholder Services. "Anger is definitely high there." *Louis La*

THE LIST TERROR'S AFTERMATH: LAYOFFS

Who knows how many of these might have come anyway? But since Sept. 11, companies have cut more than 160,000 jobs. Airlines were the hardest hit, but other industries were also affected. Here are some of the biggest:

COMPANY	CUTS	INDUSTRY
BDEING	30,000	Aerospace
AMERICAN AIRLINES	20,000	Airline
UNITED	20,000	Airline
DELTA	13,000	Airline
CONTINENTAL	12,000	Airline
STARWOOD HOTELS & RESORTS	12,000	Hotel
US AIRWAYS	11,000	Airline
NDRTHWEST	10,000	Airline
BRITISH AIRWAYS	7,000	Airline
AIR CANADA	5,000	Airline
HDNEYWELL INTERNATIONAL	3,800	Aerospace/Diversified materi
SWISSAIR	3,000	Airline
ALITALIA	2,500	Airline
TEXTRON	2,500	Aircraft manufacturing
EMC	2,400	Data storage
ADVANCED MICRO DEVICES	2,300	Microprocessors
AMERICA WEST	2,000	Airline
APPLIED MATERIALS	2,000	Semiconductors
MIDWAY	1,700	Airline
VIRGIN ATLANTIC	1,200	Airline

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Up Front

PLANE TALK

AIRPORTS ARE IN A HOLDING PATTERN

IT'S NOT JUST AIRLINES THAT are in deep trouble after the Sept. 11 terrorist attacks (page 64). Airports are hurting, too. In the weeks since the attack, officials in at least 14 cities—including Atlanta;



CONSTRUCTION HALT: Changing rules?

Boston; Dallas; Detroit; Fort Lauderdale; Manchester, N.H.; Miami; Orlando; Raleigh, N.C.; Salt Lake City; San Francisco; and Tampa—have said that runway, terminal, and parking-deck expansions

would be halted or placed under review.

Why? The attacks, as we know, have slashed air traffic for the time being. But more important, airport administrators are waiting for revised—and probably expensive—security requirements to be announced by Transportation Secretary Norman Mineta by Oct. 1. “We’re trying to see what our new life will be,” says James Koslowski, chairman of the American Association of Airport Executives. Vendors are also pulling out of contracts for fear that heightened security—such as barring friends and family from the gates—will severely cut into revenues. Some airports, at least, including three in Houston undergoing \$2.7 billion worth of expansions, will continue.

But there will be little help from the feds: The House Committee on Transportation & Infrastructure has put \$3.3 billion in funds earmarked for airport upgrades next year on hold. Looks as if air travel won’t get easier anytime soon. *Brian Grow*

THE BIG PICTURE

STOCKING UP

After the World Trade Center and Pentagon attacks, many Americans planned to change their behavior in anticipation of continued violence.

RESPONDENTS WHO SAID THEY WOULD:

AVOID FLYING ON AIRPLANES	42%
CUT BACK ON SPENDING	40
STOCKPILE EMERGENCY SUPPLIES	30
AVOID PUBLIC PLACES	14
BUY AND STORE EXTRA GASOLINE	14

Survey of 1,082 Americans, Sept. 13, 2001
Data: Harris Interactive

DRAWN & QUARTERED



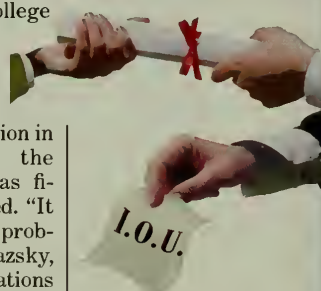
JOB WOES

STUDENT DEFAULTS IN TERROR'S WAKE?

WITH A BAD JOB MARKET made worse by terrorism-related layoffs, recent college graduates are finding it harder to find work—and keep it. About 46.3 million former students owe a total of \$150 billion in college loans. And the stormy job climate has financial-aid types worried. “It could cause repayment problems,” says Nina Prikazsky, vice-president for operations at lender Nellie Mae. Adds Greg Leis, an adviser to USA Funds, the nation’s largest guarantor of student loans: “We could begin to see an increase [in defaults] around year’s end.”

For borrowers still in school, USA Funds is preparing to launch a campus pilot program called Life Skills designed to head off future defaults. With college costs continuing to rise and with the average student owing nearly \$10,000 at graduation, finan-

cial-aid counselors welcome anything that might help. “Many students don’t have any idea how much of a debt they’re incurring—and they’re incurring—and they don’t have any idea what it’s going to take to repay that debt,” says a



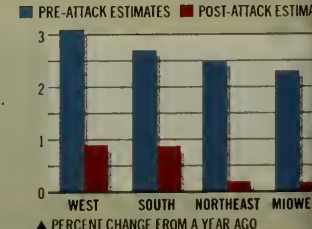
gram spokesman. Even though defaulting on student loans fell steadily during eight years of economic boom in the 1990s—from 22.4% to 5.6%—it’s a different environment now.

Students at the 25 institutions offering the financial planning project may be asked to do extra homework, such as watching a video and working on a workbook that explains how to save money. Needless to say, the cost of the program is pass/fail. *Julia Cosgrove*

REGIONAL IMPACT

Although the attacks will have an immediate economic impact on New York and Washington, analysts forecast a ripple effect. Declines in tourism will hit hard (South, West), as will airplane manufacturing (West), and insurance (Midwest).

OUTLOOK FOR REAL OUTPUT IN SECOND QUARTER



Data: Economy.com

Polls, surveys, and other items for consideration in this section should be sent to upfront@businessweek.com

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THE ECONOMIC FALLOUT MAY NOT BE SO HEAVY

Everyone is revolted by the terrorists' act of barbarism and their disregard for human life ("Terror in America," Special Report, Sept. 24). However, to say that the events spell economic catastrophe seems totally unbalanced and defies the historical evidence. I am certainly not condoning the disaster (or



war), but I believe that there is compelling evidence that the longer-term effect of such events in the past has been positive rather than negative for our economy.

Pearl Harbor and World War II propelled this nation out of the Depression. Hurricane Andrew (of which I have personal knowledge) caused rebuilding and the resultant spending drove the economy. The U.S. (and the world) needs encouragement. You should see that as your editorial responsibility as well as your civic duty in this time of national tragedy.

Thomas L. Burnett

Boca Raton, Fla.

The whole series of articles on this national tragedy was slanted toward predicting the devastation of the economy. Let's hope that the courage and determination of the American people proves this wrong. The country and the President need and deserve all our sup-

port and commitment. President George W. Bush is doing a superb job and has strong and experienced staff to get through this difficult time. The economy has been supported by an outpouring of funds from the government, the Federal Reserve, private corporations, and proud American investors.

Shirley H.

Adams, Ma

This is the time—perhaps the most important time in recent U.S. history—for the nation to unite in support of our leader. The President is trying to pick up the pieces from the Clinton Administration's inability to fight off terrorism and provide a safe haven for the American people. Thank God we have a leader who is fully dedicated to increasing the budget and power of our national defense.

Erin Gr

Columbus, O

RETHINKING AMERICA'S PLACE IN THE WORLD

One historian quoted in "Terror in America" (Special Report, Sept. 24) says: "It will shake the way America thinks about their place in the world. Maybe it has escaped the average American and President George W. Bush lately, but America has always been looked at as the leader to follow, especially by the populations (if not their leaders) of Third World countries aspiring to mimic the American way of life and the freedom and democracy to come with it. Whenever the U.S. turns toward isolationism, those who look to her as a model feel betrayed."

Those who think that this is a religious war are mistaken. Muslims pray to the same God as Christians and

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NOTE TO READERS:

Because of *BusinessWeek's* printing schedule, we were unable to remove some advertisements from the Sept. 24 issue (with the "Act of War" cover) that may have been perceived as inappropriate, given the nature of the week's news. Unfortunately, these ads had already been printed and could not be pulled from the issue. Our apologies to J.D. Edwards, Suez, and any other advertisers that were affected.

Jews. Suicide is banned by Islam: Indeed, if a Muslim commits suicide he is not even entitled to a prayer on his tomb. *Jihad* is a defensive act, not an offensive one, and has nothing to do with killing innocents. Unfortunately, history is filled with politicians hijacking religion to enhance their own agenda. Those who do recruit desperate people living in a den of misery. The U.S. must tackle the roots of the desperation that leads people to commit such desperate and reprehensible acts.

Ali Nsouli
Geneva

A DANGEROUS DEPENDENCE ON FOREIGN OIL

We cannot neglect that the resources that funded this affront to civilization came from the wealth created by the West's dependence of Middle Eastern oil. The "War on Terrorism" must include the financing of a new "Manhattan Project" with the aim of developing alternative energy sources as a matter of national security. This project should enlist the best minds of our country and our allies for a feverish, tireless quest to develop plentiful, safe, and economical fuel resources that will replace our dependence upon foreign oil and our subsequent funding of anti-American interests.

David E. Newberger
Des Plaines, Ill.

SAVE FLYING FOR THE LONG HAUL

I have long thought there are too many airports and short flights ("How much heavier can the baggage get?" Special Report, Sept. 24). Before any money is sent out, the feds should work on an integrated transportation system that leaves flights to the true long haul.

Wolfgang Sailler
Salem, Ore.

THE PRITZKER EMPIRE HAS PLENTY OF FOCUS

"An empire trembles" (People, Sept. 10) about the Pritzker family businesses, characterizes Marmon Group as an "almost arbitrary collection of businesses." When my brother Jay and I went into business together in 1953, we didn't use our family's capital. We pursued various opportunities, many of which turned out quite well for us. Our growth, through internal expansion and acquisitions, has been such that our companies collectively rank first, second, or third in the U.S. or the world in many industries. Diversity should not be mistaken for lack of focus.

In 2000, the Marmon Group member companies achieved sales of nearly \$6.8 billion and net earnings of \$300 million. If our performance falls short of anyone's expectations, the blame rests entirely with me, not with others in the Pritzker family who were not involved in Marmon Group's management. I'm proud of our record and of the 40,000 employees who continue to build on it worldwide.

Robert A. Pritzker
President and CEO
Marmon Group
Chicago

BROADBAND WILL DRIVE THE INTERNET'S EVOLUTION

"Broadband baloney" (e.biz, Cutting Edge, Sept. 3) understates the value of an always-on world that consumers experience from a broadband connection. Prodigy Communications LP, a 17-year-old Internet pioneer, sees broadband driving the next evolution of the Internet, as it enables the Net to shift from an entertainment medium to more of a household utility.

We're completely redesigning our software and home page with a broadband focus so that we can give demanding consumers the tools to be active participants with the Internet, not merely passive viewers of videos or pop-up ads.

Paul Roth
President and CEO
Prodigy Communications LP
Austin, Tex.

FANNIE MAE: LENDERS DON'T GET STUCK WITH DEFAULTED LOANS

"A housing collapse could wound the banks" (News: Analysis & Commentary, Sept. 3) incorrectly states that a cooling of the housing market would wound the

banking industry—because the ordinary-mortgage market would require lenders to repurchase defaulted loans.

Since 1981, [Fannie Mae's repurchase policy] has delegated to lenders the termination of whether a loan met our underwriting guidelines. If we find that a defaulted loan has an underwriting deficiency, we may ask the lender to repurchase the loan. Lenders have recourse to an independent third-party review committee.

We do not ask lenders to repurchase defaulted loans that met our underwriting standards. In fact, of the 10.5 million mortgage loans that Fannie Mae currently owns or guarantees, we ask lenders to repurchase only 0.01% of those in 2000.

Michael A. Quinn
Senior Vice-President
Fannie Mae
Washington, D.C.

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MARINE PUMPS

WAR IN A TIME OF PEACE
Bush, Clinton, and the Generals
 By David Halberstam
 Scribner • 543pp • \$28

NOT HALBERSTAM'S BEST OR BRIGHTEST

David Halberstam's new book, *War in a Time of Peace*, is billed as a follow-up to his 1972 best-seller, *The Best and the Brightest*. Like the earlier estimable work, which focused on the Vietnam War, this volume delves into the personalities, politics, and policies that lie behind America's national security strategy. Unfortunately, this literary effort, like many movie sequels, doesn't measure up to the original.

Halberstam starts out at the apogee of the first Bush Administration—the Persian Gulf War. He goes on to describe Bush's subsequent political downward spiral. The President was in a good position to profit electorally from the collapse of communism and from his qualified defeat of Saddam Hussein. Yet

he failed to reach the voters in the next election—since they were primarily concerned about domestic affairs, particularly the sputtering economy. Bill Clinton realized this early on and hammered home that voters needed someone who cared about the Middle West as well as the Middle East. But, as Halberstam shows, Clinton, too, found himself unable to avoid entanglement in foreign policy issues—and may have even sought refuge in them during the Monica Lewinsky scandal.

In covering the Bush and Clinton Ad-

ministrations, and just touching George W.'s time in office, *War in a Time of Peace* devotes considerable attention to the difficulties that regional strife poses for Europe and the Middle East. But the book arrives at a peculiar conclusion—for which Halberstam can hardly be faulted. It went to press well in advance of the terrorist attack and sheds no light on how the U.S. should handle terrorism.

Still, the author makes some points that are worth noting in the aftermath of September 11. One is that since the end of the cold war, foreign policy initiatives have provided few benefits for a President but considerable risks. For example, President George H.W. Bush's stellar ratings in the polls after Operation Desert Storm, for example, did not last for him in 1992 as the economy worsened more about the economy. The book leads

you wondering if his son will face the same problem: a huge liability if he fails in his campaign against terrorism and little payoff if he succeeds and the economy falters. Or is the political e-



somehow altered by the fact that World Trade Center isn't in some unt, hard-to-pronounce city such as adishu or Sarajevo?

second important point Halberstam es is that after the decision to use military in Kosovo, the generals—in icular, General Wesley K. Clark, the reme Allied Commander in Eu—had considerable leverage. Polititi don't want to be blamed for losing r out of failure to heed the genererequests. So when Clark pushed for introduction of ground troops, the te House felt considerable pressure along. If Serbian strongman Sloon Milosevic hadn't agreed to NATO's is, American G.I.s might well have sent in. The current President ld consider the potential political of the military brass as he plans a aign in a region that has bloodied y a big army.

his book, Halberstam has accumulan immense amount of reportage, he rakes over well-tilled ground. would have been O.K. had he prodl insightful analysis along the way. ricanis could benefit—especially now—from an examination of U.S. de-flexing in such 21st century hot as the Balkans, Haiti, and Somalia. readers won't get that from Halcam. For an enlightening discussion

The author rakes over previously tilled ground, with little insightful analysis

of these moral blind alleys, where intervention and nonintervention are equally excruciating options, the recently published *Wilson's Ghost*, by Robert S. McNamara and James G. Blight, is a much better choice.

Another opportunity Halberstam misses is in his treatment of two key Clinton Administration figures, National Security Adviser Anthony K. Lake and diplomat Richard C. Holbrooke. Both play central roles in this book and provide a thread of continuity with *The Best and the Brightest*, since as young men they served in the Vietnam-era State Dept. As they grew older and assumed greater power within Democratic policy circles, their disillusionment with the handling of the conflict led them to search for ways Democratic Administrations could improve their execution of foreign affairs. If Halberstam

had restricted his story to the evolution and changing roles of these two men—who were friends at first and became rivals later—he might have created a riveting tale.

The author chose to paint with a broader brush. As a result, we get repetitive portraits not only of Lake and Holbrooke at different junctures, but also of everyone from George H.W. Bush to General Clark, and Air Force Colonel John Warden, a strong advocate of air power in the Balkans. Often introduced as digressions from the book's chronological narrative, these profiles are so numerous and lengthy that they become a serious annoyance.

Finally, there's Halberstam's fascination with air power. He clearly has bought the Air Force argument that bombing campaigns alone can win wars. But it's also a possibility that Russia's withdrawal of support—not U.S. bombing—led Milosevic to cave on Kosovo. Likewise, bombing Afghanistan is unlikely to quash terrorism. The fact that the Bush team launched diplomatic, financial, and intelligence campaigns before any bombing may be a sign that his team already understands this critical lesson.

BY STAN CROCK

*Crock is chief diplomatic
correspondent.*

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Reviews and more are available on AOL (Keyword: BW) or www.businessweek.com

ON THE RISE

TWO HISTORIES OF THE WORLD TRADE Center have become hot sellers: Angus Kress Gillespie's 1999 *Twin Towers* (Rutgers, \$26) and Eric Darton's 1999 *Divided We Stand* (Basic, \$15, paperback).

Darton's deft account explores the development, building, and life of the complex, explaining how it came to embody the renewal of downtown Manhattan. But the author reminds us that this was not without cost: There are tales of controversial financing, steamrolled community opposition, real estate

speculation, and questionable deals with corporate tenants. At times, Darton seems eerily prescient. Reflecting on 1993 bombing, he writes: "A traumatic event of this magnitude, with its horrific loss of life, opens up disquieting questions of how we have come to build and live in structures are powerless to defend." Later he asks: "Is it possible to imagine the World Trade Center as a ruin?" What we would give to still have that exist only in our imagination.

BY KARIN PEKARC

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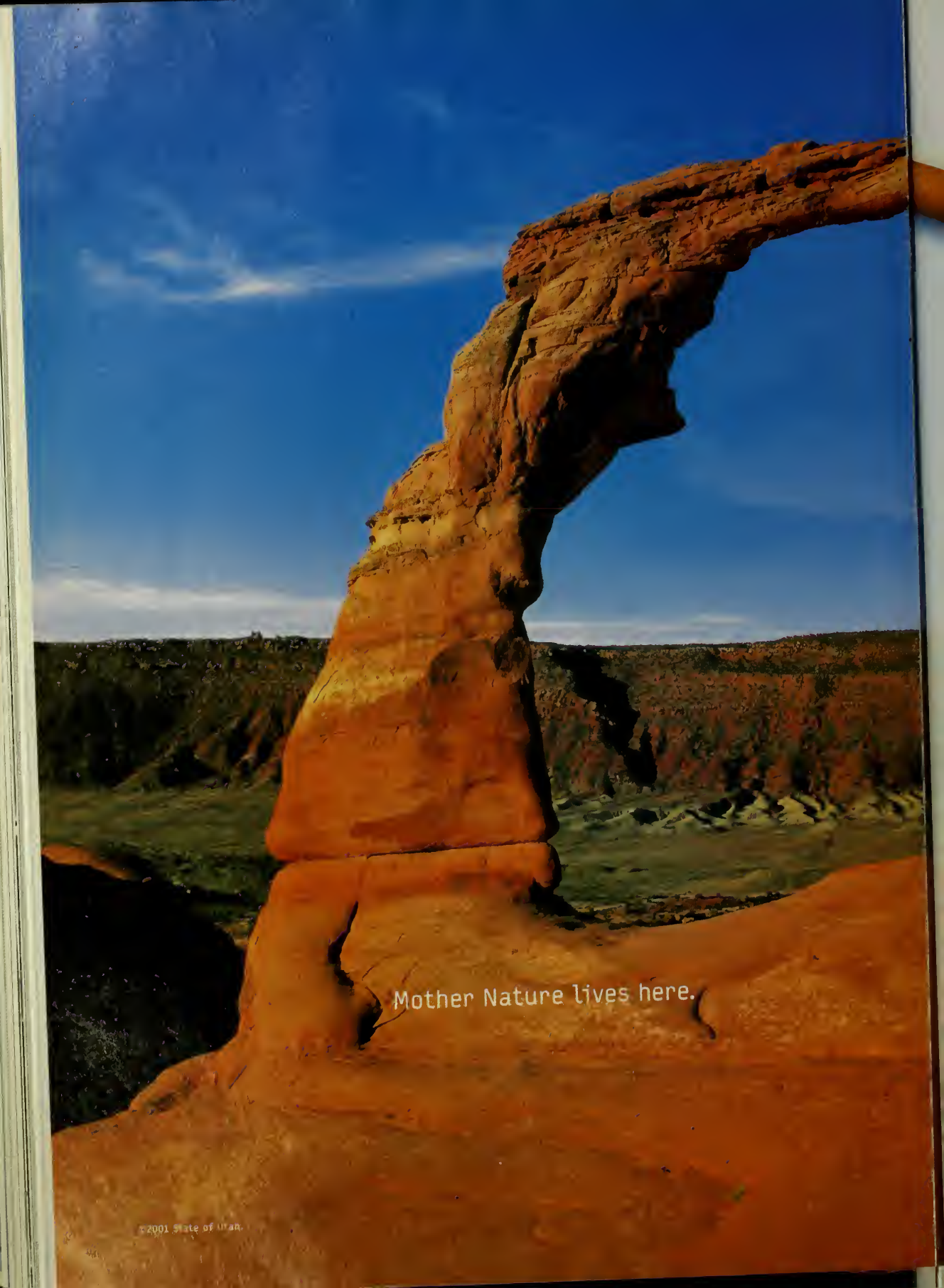
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A photograph of a large, reddish-brown rock formation with a natural archway. The rock is layered and textured, with a prominent archway in the center. The background shows a green valley with some trees and a blue sky with a few wispy clouds. The overall scene is a natural landscape.

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BY STEPHEN H. WILDSTROM

tech&you@businessweek.com

WINDOWS XP: TIME TO BUY A NEW PC?



Users of older laptops with Windows 95 or 98 may have the biggest incentive to upgrade

Windows XP, the new operating system from Microsoft, will place a lot more demands on your computer, so millions of people, especially those with computers more than two years old, may need new ones. By the time you read this, direct sellers such as Dell and Gateway should have begun shipping Windows XP desktops and laptops on customer request, though Microsoft won't let them advertise until the new operating system officially goes on sale on Oct. 25. Is it time to rush out and buy?

As I explained in a recent column (Sept. 10), XP represents a major advance in stability and ease of use, especially for those whose computers run Windows 95, 98, or Me. And the older your system, the more you will gain by replacing it. (I will look at the issues posed by upgrading existing computers in an upcoming column.)

Still, the release of XP doesn't change the basic criterion for upgrading your hardware, whether or not it's adequate for XP (table): How satisfied are you with what you have? If your PC meets your needs, even if it is a five-year-old Pentium 166 running Windows 95, there's no reason to scrap it just because Microsoft has released a new operating system. On the other hand, if you are on the fence, XP gives some potent reasons for a move.

Users of older laptops running Windows 95 or 98 have the largest incentive to buy. Not only have notebook computers themselves gotten much better and cheaper in recent years but Windows XP brings big gains in usability. Many of these have been available for nearly two years in the corporate-oriented Windows 2000, but not in any consumer version.

RESTFUL SLEEP. Perhaps most important is the ability to have your laptop go into a power-saving sleep after a period of inactivity. Suspend never worked properly in any consumer version of Windows. Sometimes Windows 98 would refuse to suspend and give you no clue why. On the relatively rare occasions that XP has trouble, it usually can identify the source so you can close the offending program. More significantly, XP notebooks wake up. All too often, earlier versions forced you to reboot to keep working. A reliable ability to suspend means you will rarely need to turn your notebook off. It will resume within a few seconds of being awakened with

programs and files open just as you left the PC. XP also brings much more powerful and flexible networking, making it a lot easier to use a computer on both office and home networks, including dial-up Internet access. One of the relatively few areas where XP is a big advance of 2000 is its ability to sense the presence of a wireless local area network—say, in an airport lounge—and set your computer to work on it.

The case for rushing out to replace a desktop is less compelling. If you can't face one more crash or "illegal operation" error that forces you to reboot, a new XP computer should solve the problem. If you want to share a computer among family members with everyone having his or her own preferences and individual private files, XP is again the answer. And an XP box is far better suited to serve as the hub of a home network than one running Windows 95 or 98.

But there's a downside for owners of older systems. Some hardware accessories that worked under Windows 95 or 98 won't work with

THE RIGHT STUFF FOR WINDOWS XP

For many people, taking advantage of the new Windows XP operating system may require buying a new computer, especially if your computer is more than two years old. Here are the critical elements to look for:

MEMORY This has the biggest impact on performance. Microsoft recommends 128 megabytes; 256 MB is better.

PROCESSOR Almost any new one will do. Microsoft recommends at least a 300 MHz Pentium II. Few new computers these days come with a processor slower than 800 MHz.

DISPLAY On a laptop, you'll want a display with at least 1,024 by 768 pixels. On a desktop, go for at least a 17-in. CRT monitor or a 15-in. flat panel.



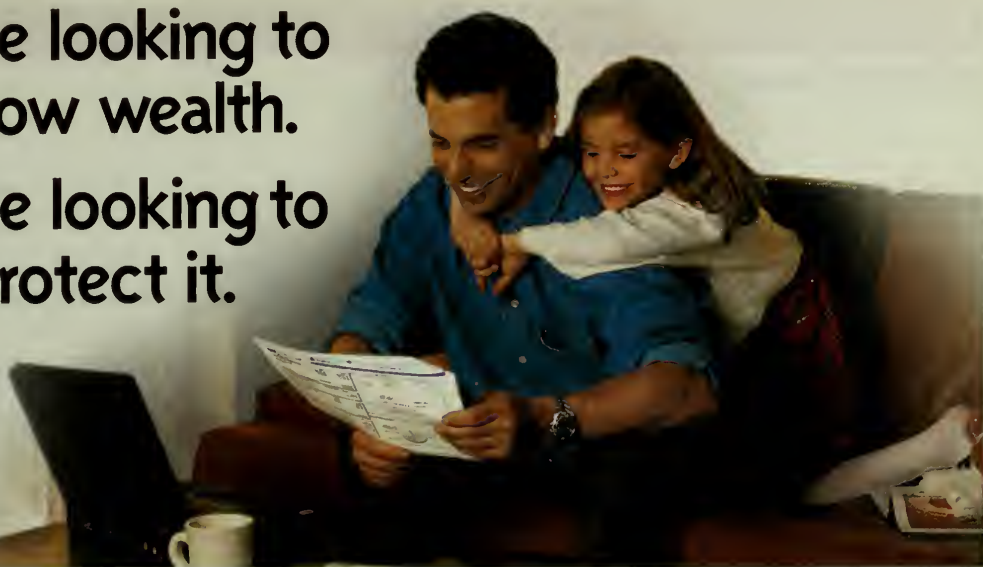
without software upgrades, which are provided by the device manufacturer and distributed by Microsoft. Companies are working to get their upgrades finished, and XP will automatically check online for new software during set-up. But if the manufacturer of your scanner has gone out of business, or if the maker of a 10-year-old printer decides not to write new software, you may be out of luck. (You can check hardware compatibility at www.microsoft.com/hcl/, but the changes daily.)

Windows XP offers a lot of attractive new features, but I can't argue that everyone needs it right away. If you have been keeping your system alive just waiting for XP, you'll want to jump at the first opportunity. If you have been thinking about buying a new system, XP will give you the reason you have been looking for. But if you are happy with what you have, there's no reason to rush out and change.

BusinessWeek online

XP ISN'T THE ONLY NEW GAME IN TOWN. For a look at the new version of Apple's OS X, see Technology & You at www.businessweek.com/technology/.

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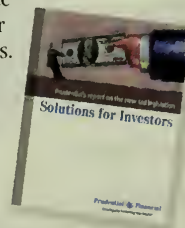
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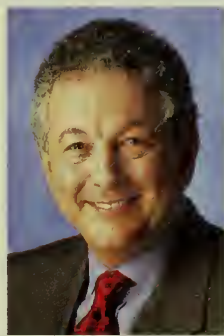
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BY JEFFREY E. GARTEN

CHINA IN THE WTO: LET'S CUT IT SOME SLACK



HUGE JOB: Beijing will be hard-pressed to make the changes it committed to for WTO entry. To prevent a nationalist backlash, the West must be patient

Jeffrey E. Garten is dean of the Yale School of Management. A former investment banker, Garten is the author of *The Mind of the C.E.O.* (jeffrey.garten@yale.edu).

America's war against terrorism puts a tough geopolitical overlay on its international economic interests. It will require Washington to deepen ties with countries that sign up as allies and spurn those that don't. Among the biggest questions is whether China will join the coalition. So far, there are hopeful signs, such as the pledge by Foreign Minister Tang Jiaxuan, made to President Bush on Sept. 21, that Beijing was willing to share some of its intelligence information.

Yet the heart of U.S.-China relations in the months and years ahead will be trade, which has become much more than just a commercial issue. China is now certain to be admitted into the World Trade Organization in the next few months. Soon, it will be clear that the 15 years of tortuous negotiations to get China into the club will be seen as much easier than dealing with the Middle Kingdom as a member. If China makes good on its commitments to join the anti-terrorist effort, it will need, and deserve, American help in dealing with at least four upcoming economic flash points.

First, in order to join the WTO, China made extraordinary concessions, and there could be an internal backlash against adhering to its obligations. Beijing has committed to tariff rates that are lower than any other developing country, and it has forgone the use of key subsidies that the WTO normally permits. It has allowed other governments to shut out its goods with much less justification than required under existing international trade law and permitted them to retain import restrictions on textile and clothing products for an unusually long time.

LEGISLATIVE CHALLENGE. Second, it is unlikely that Beijing can implement all of its commitments, which could lead to harassment from its trading partners. For example, China has to gain the cooperation of far-flung provinces that will resist the widespread deregulation required by the WTO. It also has to amend more than 170 laws and regulations just to modernize its customs procedures, let alone all of its other statutes. It must establish an effective legal system for protecting intellectual-property rights, not to mention independent regulators for telecommunications and modern financial legislation. These are goals that took the U.S. at least a half-century to achieve.

Third, Beijing is likely to emerge as an exporting superpower, aggravating America's trade deficit and fanning protectionist pressures in a slumping world economy. China is sucking in-

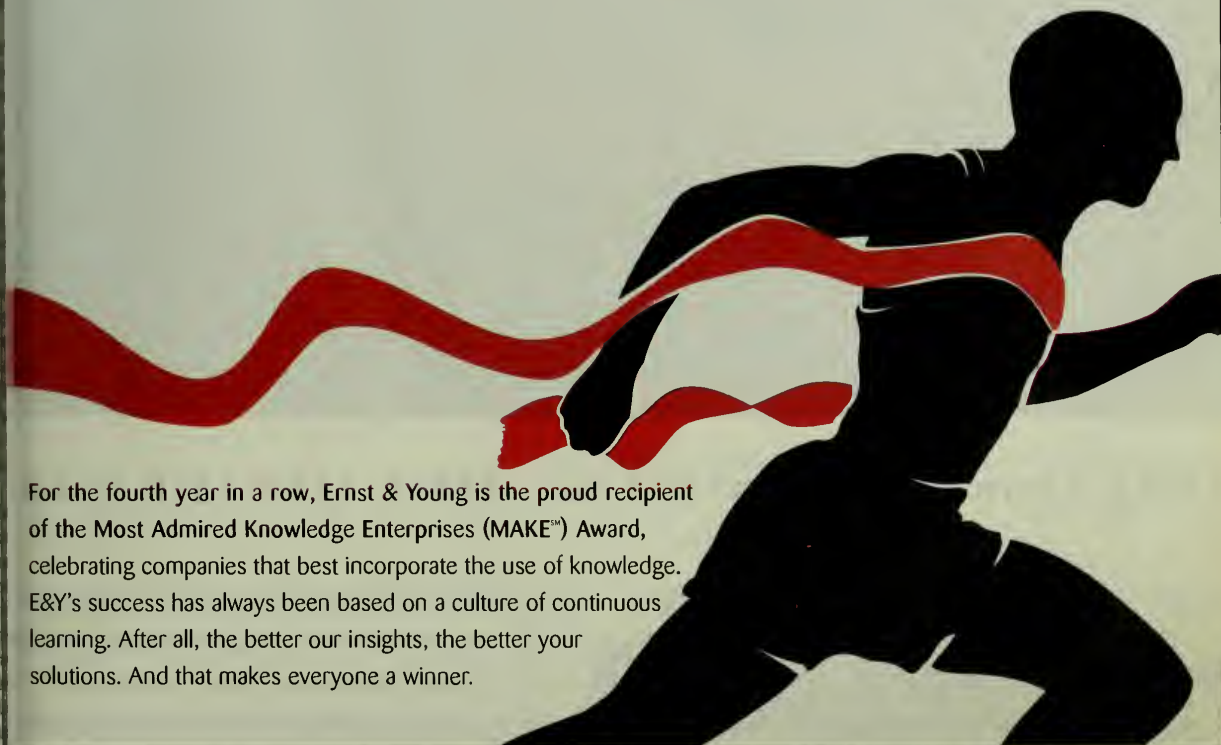
vestment and production out of countries as diverse as Japan and Malaysia, and it is rapidly becoming the manufacturing hub for all of Asia. In the past decade, Japan has halved its investment in Southeast Asia and doubled it in China. Last year, Taiwan invested \$1.5 billion in China, five times the 1999 amount. Meanwhile, a host of indigenous companies, such as Legend (computers), Huawei (switching equipment), and Konka (TVs) are becoming super-competitive international companies.

Fourth, China's entry into the WTO will radically alter current trade politics. Beijing will want not just any seat but one on the dais. It is likely to veto any behind-the-scenes agreement concluded by the U.S., EU, Canada, and Japan. The cozy club that has until now run the WTO. Beijing will champion developing-country demands for lower trade barriers to their exports and for more constraints on Western antidumping policies.

ON THE UPSIDE. Not everyone is worried. The Brookings Institution's Nicholas Lardy, who will soon release *Integrating China In The World Economy*, a thoughtful and comprehensive analysis of China's entry into the WTO, expresses cautious optimism. He believes China has already made substantial internal policy adjustments to prepare for membership. Former U.S. Trade Representative Charlene Barshefsky, who negotiated the China deal for the U.S., told me that China's commitments to the WTO could be the foundation for essential internal reform. But both agree that China's leadership has gambled its legitimacy and its survival on the assumption that WTO membership will make people better off. If that proves to be wrong, China's intertwined economic and political relations could degenerate into chaos or extreme nationalism.

Assuming that China is willing to help the U.S. combat terrorism, Washington needs a plan that presses Beijing to deliver on its WTO commitments yet makes allowances for the extreme difficulties of doing so. First, China would have to share intelligence, refrain from exporting military equipment to rogue states, and help to catch terrorists if it can. In return, President Bush would have to rein in Congress' protectionist tendencies, provide extensive technical assistance to China to help it implement the accord, and lead the Group of Eight countries toward similarly sensitive policies. Of course, if China lets Washington down, it should expect to pay a high price.

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BY MICHAEL J. MANDEL

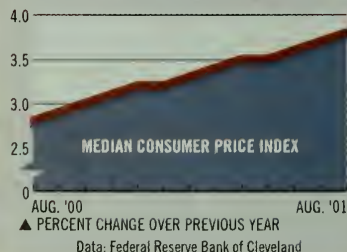
EARLY INFLATION SIGHTINGS

The "median CPI" raises a red flag

The latest price reports from the Bureau of Labor Statistics suggest that the U.S. was in good shape on the inflation front when the Sept. 11 tragedy hit. In August, consumer prices rose at only a 0.7% rate. Core inflation—omitting food and energy—was only 2.6%, barely above where it was a year earlier. Such positive inflation news has made it easier for the Federal Reserve to slice interest rates.

But an alternate measure of core inflation, calculated by the Federal Reserve Bank of Cleveland, presents a far less optimistic picture. Each month, the bank calculates what it calls the "median consumer price index," which smoothes out some of the big month-to-month changes, not only in food and energy but also in other commodities that may be distorting the index. The result: Inflation, measured by the medi-

A DIFFERENT LOOK AT INFLATION



an CPI, rose at a 4.2% rate in August. What's worse, the price hikes are accelerating. The median CPI is up by 3.8% over the year ending in August, compared with 2.8% a year earlier.

The implication is that inflation, by conventional measures, may rise soon as well. "The median is a good measure of the medium-term inflation trend," says economist Stephen G. Cecchetti of Ohio State University, who with Michael F. Bryan of the Federal Reserve Bank of Dallas first proposed the median CPI in 1994. Over long periods, both the conventional and median CPI rise at roughly the same rate. But in the short run, the median CPI is less affected by temporary price changes that may not reflect the underlying inflationary trend.

In August, for example, the conventional inflation rate was pulled down by sharp declines in prices not just of food and energy but also of such items as tobacco products and men's and boys' apparel. Indeed, the price of tobacco products fell at a 37% annual rate in that month, a startling drop that is unlikely to be repeated. In contrast, the median CPI gives less weight to such big but misleading price movements.

This suggests that the Fed may have less of a cushion against inflation than it thinks. "Inflation will now tick up, probably over 3%, in the short term if everything goes well," says Cecchetti, a former research director for the Federal Reserve Bank of New York. Such a rise in inflation could keep long-term bond rates high even as short-term rates are cut. Moreover, higher inflation could force the Fed to raise interest rates faster once the recovery begins.

Still, inflation concerns take a back seat to current problems. "We could easily be in for a rather protracted period of stagnation" says Cecchetti. "It would surely be better to live with a small amount of extra inflation now and worry about it when growth goes back to a steady 3% or more."

OIL: INVESTORS HAVE IT WRONG

Demand may not fall, but supply will

As fears of recession have risen in the U.S., oil prices have declined on the expectation that consumption of everything from gasoline to jet fuel is going to fall. Indeed, as of Sept. 24, crude oil prices had dropped 22% since the attacks, to \$21.50 a barrel.

But instead of worrying about a demand slowdown, perhaps investors should be concerned about a shortfall in supply. According to a Sept. 20 report by Raymond James & Associates in Houston, rising tensions in the Mideast mean there's an 80% chance that U.S. oil supplies will be disrupted in the next two years. Shorter term, it says, there's a 20% to 30% chance of a supply interruption if the U.S. targets terrorist organizations linked to oil-producing countries such as Iraq and Iran.

Since the U.S. imports about 60% of its oil, a reduction in supply from overseas would push prices higher. If oil supplies to the U.S. were to fall by 3 million to 4 million barrels a day, for example, crude oil prices could soar as high as \$40 to \$50 a barrel, says J. Marshall Adkins,

managing director for energy research at Raymond James. Making matters worse, U.S.

A TEMPORARY PLUNGE IN OIL PRICES?



Of course, predicting the timing of an interruption is tough. So oil prices are likely to jump \$4 to \$5 when news of an attack hits the wires, Adkins says.

By Laura Co

NATIONALISM CAN HURT TRADE

And that can slow global recovery

Most economists believe that free trade is a plus for growth. Yet free trade is highly controversial, both in the U.S. and in the rest of the world.

Now, a study from the National Bureau of Economic Research examines the factors that make people more likely to favor trade. Analyzing a survey of more than 28,000 people in 23 countries, economists Maria Mayda and Dani Rodrik of Harvard University report the expected result that well-educated people in well-educated countries are more likely to favor trade, while workers in industries exposed to foreign competition in any country are more likely to be against it.

Surprisingly, however, even well-educated workers in poorer nations tend to be against free trade. This opposition, from those who might be expected to be allies of globalization, may make it more difficult to extend free trade.

Perhaps most significant for the current situation, Mayda and Rodrik find that high levels of nationalism and patriotism are associated with support for protectionism. That suggests that sustained global conflict—which boosts nationalist fervor at home and abroad—could undermine support for free trade. And that could make recovery from the current global downturn more difficult.

By James Mehr

JAMES C. COOPER & KATHLEEN MADIGAN

MARKETS MEASURE RISK ALL THE TIME. THIS IS MUCH WORSE

Economic decisions are stymied until the U.S.'s course of action is clearer

U.S. ECONOMY

The most important economic policymakers in Washington right now are Secretary of State Colin L. Powell, Defense Secretary Donald Rumsfeld, and National Security Advisor Condoleezza Rice. Over the next few months, the outlook will depend more on military and diplomatic decisions than on fiscal and monetary stimulus. The prospect of war is now the overarching influence on the economy. The Sept. 11 attacks on New York and Washington have created a veil of uncertainty to which consumers, investors, and companies are all trying to adjust. The problem is: No one can take its measure.

This not-knowing underpins the outlooks for both the economy and the stock market. Consumers seem especially vulnerable since they were already grappling with job jitters. Now they are overcome with the fear of a war with unknown parameters and consequences. These worries caused consumer confidence to

tumble 16 points in September, the largest monthly drop since the Persian Gulf conflict. Bear in mind that uncertainty is not risk. The financial markets deal with risk every day, assessing it and pricing securities based on those assessments. Uncertainty is unquantifiable risk, and traders loathe anything they cannot put a price on. That's why the stock market had its worst week in six decades—and why the market outlook remains dim (page 36).

Uncertainties about war, its impact, personal safety, and the cost of security make military decisions paramount to the economy's future. The Federal Reserve has cut short-term interest rates down to zero, but that won't make consumers feel safer about flying (page 37). Tax rebates won't stop businesses from instituting security measures that slow down the movement of goods and people across the economy. Until uncertainty is removed from the outlook, confidence and spending decisions are unlikely to turn around.

ECONOMISTS HAVE BEGUN TO AGREE that the Sept. 11 attacks mean recession (chart). A survey of 44 economists, taken by *Blue Chip Economic Indicators*, shows that 82% of its respondents believe the economy is in recession.

The average forecast is that real gross domestic product fell at a 0.5% annual rate in the third quarter and will drop at a 0.7% pace in the fourth. In 2002, growth will slowly pick up, although *Blue Chip* cautions that forecasts are still being revised. This projected 0.6% annual rate of decline would be an exceptionally mild recession. Almost 45% of the economists believe the downturn will be far milder than the 1990-91 recession, in which real GDP slipped 2.6%.

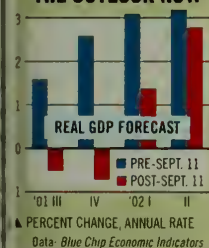
The economists forecast that falling consumer confidence will cut into household purchases at the same time capital spending remains a huge drag on growth because of falling orders and excess inventories. This combination of stalled consumer and business spending plays up a key distinction of this recession. Namely, the economy has suffered a demand shock. In past downturns, demand is choked off by higher interest rates, rising inflation, or oil shortages. Now people have stopped buying because an incredible event has altered the future in a completely unknowable way.

Initial data may overstate the economic damage. It will be important to separate the immediate shock effect, such as temporary curtailments of spending and output, from more fundamental deterioration. For example, the weekly retail survey from Instinet Research Redbook showed a plunge in buying in the week of the disaster, but then a modest rebound the following week. Even so, the monthly pace remains below August, suggesting retail buying was weakening as the third quarter drew to a close.

THAT SOFTNESS MAY REFLECT the fact that consumers were turning cautious before the attacks. The Conference Board's index of consumer confidence dove to 97.6 in September, from 114 in August. Prior to Sept. 11, confidence had been sliding across all regions of the U.S., but not surprisingly, last month's dropoff in optimism was the largest in the area closest to the attacks, the mid-Atlantic region (table).

The overall drop shows that households are also fretting over the job outlook, after the headline-grab-

HOW ECONOMISTS SEE THE OUTLOOK NOW



HOW CONSUMERS ARE FEELING ACROSS THE COUNTRY

	MONTHLY CHANGE IN CONFIDENCE INDEX		
	JAN.-AUG. AVG.	AUG.	SEPT.
NEW ENGLAND	-0.2%	-15.0%	
MIDDLE ATLANTIC	-1.4	-18.7	
EAST NORTH CENTRAL	-2.5	-15.8	
WEST NORTH CENTRAL	-3.5	3.6	
SOUTH ATLANTIC	-1.5	-14.9	
EAST SOUTH CENTRAL	-2.3	-4.3	
WEST SOUTH CENTRAL	0.1	-17.1	
MOUNTAIN	-2.8	-9.9	
PACIFIC	-2.4	-11.1	
TOTAL U.S.	-1.8	-16.4	

Data: The Conference Board

INDEX POINTS

bing jump in the August unemployment rate. A key point in the confidence survey is that about 85% of the responses came in before Sept. 11, leading the board to conclude that the confidence erosion "continues to be fueled by deteriorating labor market conditions." The percentage of respondents saying jobs were "hard to get" jumped sharply in September.

As a result, the attacks' full blow to confidence may not show up until the October report—which will include revisions to the September data—especially since consumers are also coming to grips with the related drop in their stock portfolios. The plunge in stock prices in the week ended Sept. 21 made \$1.4 trillion in wealth disappear into thin air. Those losses will also play a big role in holding down consumer spending in coming months, and the degree of consumer retrenchment will determine the severity of the recession.

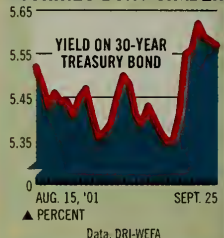
GAUGING THE DIMENSIONS of the downturn is important in assessing the potential strength of the recovery. Typically, severe recessions have been followed by strong recoveries. That's because steep recessions engender large reliquifications in consumer and business balance sheets, and they generate a backlog of pent-up demand that suddenly wants to be fulfilled. But if this downturn is as mild as expected, then the recovery could be lackluster, even if the Fed cuts rates to 2.5% or less, as 90% of the *Blue Chip* economists forecast.

Usually, prospects for weak growth would be good news for the bond market. Like most Americans, however, bondholders are concentrating more on actions by the White House than by the Fed. The prospect of military buildup plus federal money to rebuild has pushed up long-term yields in recent days (chart). Traders believe that an evaporating budget surplus will boost the supply of Treasury securities, making them less attractive as investments.

This belief ignores the fact that a recession will bring about even greater slack in the economy and in the labor market, resulting in declining inflation. Economists expect the jobless rate to rise to roughly 6% next year, and manufacturing capacity, already exceptionally idle, will only loosen up more.

Indeed, if one thing is a sure bet in these uncertain times, it's that low inflation is the economy's best asset right now. It gives policymakers at the Fed and on Capitol Hill plenty of leeway to promote a recovery. But any fiscal and monetary stimulus will not be fully helpful until military and political actions remove the albatross of uncertainty from the economy's neck.

A DWINDLING SURPLUS WORRIES BOND TRADERS



BRITAIN

WILL CONSUMERS KEEP THE ECONOMY AFLOAT?

The Sept. 11 terrorist attacks on the U.S. and the global fallout will pose a stiff challenge for Britain's two-track economy.

Prior to the attacks, slumping world demand had already pushed British manufacturing into a recession, dragging down overall growth. However, buoyant consumer spending, lifted by lower interest rates, strong labor markets, and rising home prices, had kept the service sector vibrant—and the economy chugging along. Plus, a U.S. recovery was waiting in the wings to lend support to manufacturers.

Now all that has changed. Economists believe Britain will struggle to grow 2% both this

year and next, but the outlook could worsen, depending on the severity of the U.S. recession and the hit to British consumer confidence and spending. Exports, already falling in the third quarter,

will drop further, and business investment is sure to suffer as businesses put capital projects on hold. Stock prices are down 9% since the attacks.

The manufacturing slump will only deepen. Based on a pre-Sept. 11 survey by the Confederation of

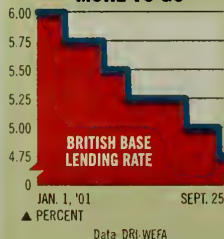
British Industry, September factory orders fell to a 2½-year low. Post-Sept. 11, travel and tourism are down, and British Airways PLC is cutting payrolls and flights. The CBI's quarterly survey and the

purchasing managers' report, due in October, will give the first key readings from the factory sector.

Domestic demand, while vulnerable to new weakness, will retain important supports. Rate cuts by the Bank of England, from 6% in February to 4.75%—including an intermeeting quarter-point cut on Sept. 18—will help to shore up private consumption. The monetary authorities are expected to follow with another quarter-point cut at their Oct. 4 meeting. Other major central banks made half-point moves after the crisis.

Also, government spending on health, education, and transportation is starting to pick up in line with previously announced spending plans. In the next few months, however, measures of consumer confidence and spending hold the key to the outlook.

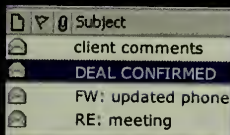
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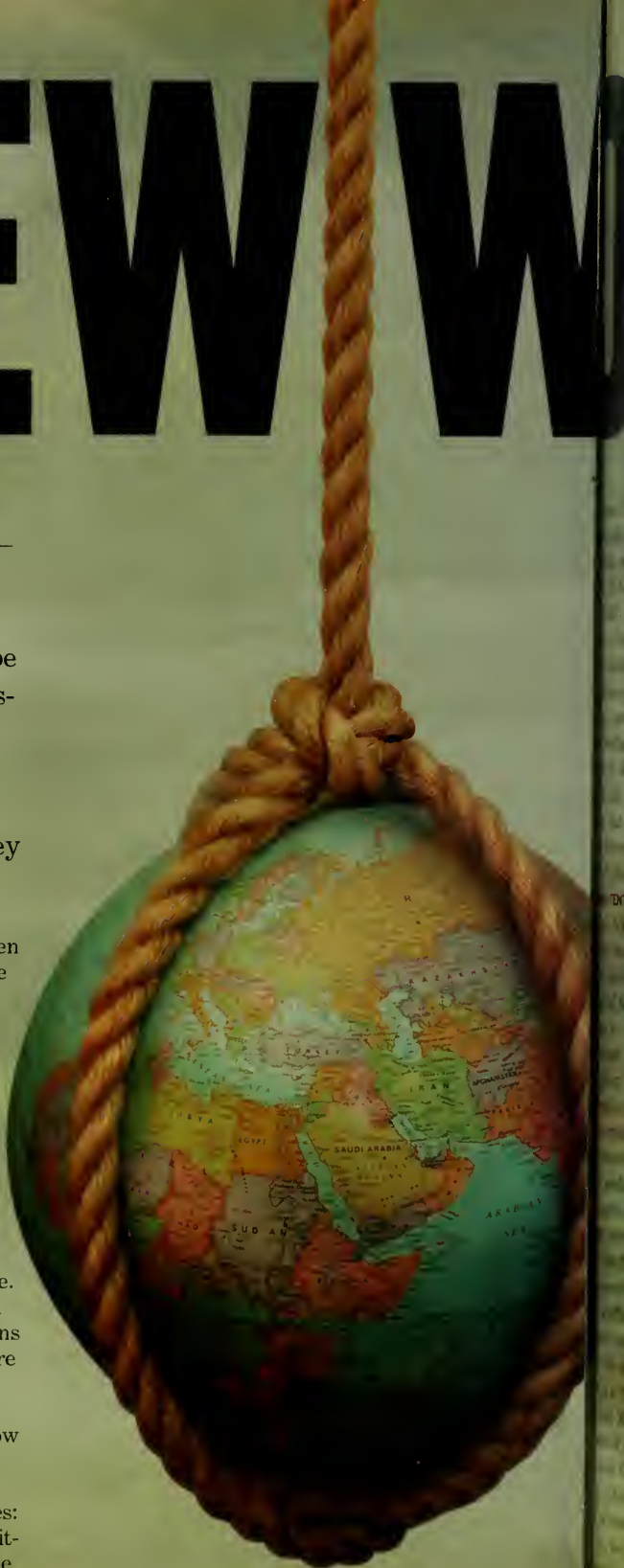
A NEW W

By Pete Engardio

The new millennium really began on Sept. 11, 2001. True, the economies of the U.S. and the rest of the globe were showing worrying signs of distress in the weeks and months before terrorists crashed three passenger planes into the World Trade Center and the Pentagon. But by striking down a key pillar of America's leadership—its unbridled faith in its own security—the catastrophe has plunged the world into an uncertain new era. A decade ago, when the cold war was history and nations rushed to embrace free markets, the world seemed united by shared opportunity. It now seems united by a dread of risk.

As the aftershocks of Sept. 11 ripple across America and on through Mexico City, Frankfurt, and Hong Kong, it's too early to fathom the contours of this new age. Economists, who make their best guesses based on the evidence at hand, are lopping anywhere from a half-point to two percentage points off their 2002 growth forecasts for the U.S., Europe, and East Asia. But talk with business leaders, investors, and consumers around the world, and you get the unmistakable sense that the impact will be far more extensive. If Wall Street rallies, and the U.S. economy picks up in a quarter or two, the question remains whether the gains will be sustainable. "All economic and profit forecasts are null and void," says economist Henry Kaufman.

What really spooks business is the sheer uncertainty. When it comes to conventional risk, the markets know how to hedge against possible loan defaults, say, or currency swings and changes in government. But they don't know how to navigate in an utter fog. Among the imponderables: Will President George W. Bush's war on terrorism be limited to Osama bin Laden and the Taliban government inside Afghanistan, or will it be an open-ended conflict that engulfs much of the Islamic world? Where will the extremists strike next? As police round up suspects across the globe,



WORLD

Uncertainty is spooking business and the markets

clear the targets include not only America's heartland, citadels of capitalism from Paris to Tokyo. Even in Indonesia, police suspect Afghanistan-trained terrorists in the Sept. 23 bombing of a shopping mall.

What's more, disaster struck at the worst possible time in the business cycle. The U.S., Europe, and Japan are sliding into a rare synchronized slump. America's confidence in the promise of equities, the magic of technology, and the brilliance of celebrity CEOs was shaken by the Nasdaq meltdown that erased \$5.4 trillion in wealth between March, 2000 and April, 2001. Now, the markets must mull the implications of the \$1.4 trillion in market value that vanished in five days of panicked selling after Wall Street reopened on Sept. 17, the biggest one-week drop since 1933.

PERSISTENT HAZARDS. Signs of risk now pervade the globe. Japan's Nikkei index has plunged to depths unthinkable six months ago. Hotels, retailers, and airlines everywhere have been pummeled. Germany's Lufthansa says up to half of booked passengers on some flights aren't showing up. In East Asia, a region that is reaching crisis stage since the 1997 financial collapse, makers of everything from toys to

electronics are seeing their sales crushed for a U.S.-style rebound. In Mexico, which sends nearly 90% of its exports to the U.S., 200,000 workers have lost their jobs this year because of the slowdown—with layoffs and order cancellations on the way. “We are at the mercy of what happens in the U.S.,” says economist Mauricio Zúñiga of Mexico City’s think tank Grupo de Economías y Asociados. As the fear of emerging markets grows, so, too, has the pessimism in perpetually changing world growth. Indeed, many of the most menacing features of glob-

alization are being called into question. For emerging markets, the wide-open capital markets promoted in the 1990s now look like persistent hazards as—yet again—investors rush to yank funds out of Brazil, Korea, and other lands thousands of miles removed from lower Manhattan’s ground zero. The explosion in international travel, thanks in part to freer borders, also has made it hard, if not impossible, to track the movements of criminals and terrorists. And it turns out that the liberal inflows of skilled labor and students that the U.S. has welcomed also included the perpetrators of the World Trade Center attack.

The impact extends far beyond commerce. Now that terrorist networks have become the global enemy America has lacked since the end of the cold war, a geopolitical realignment may be under way. The Bush Administration has a new ally in Vladimir V. Putin’s Russia, with which it had sparred over missile defense. In return for use of Pakistan’s air space and intelligence, the U.S. is set to throw billions of dollars in aid at a military regime it had largely shunned a few weeks ago. China, which U.S. hawks have been building up as America’s No. 1 strategic threat, looks less menacing.

The global unity now being shown in the war on terrorism, in fact, could well be one of the few positives to come from this crisis. Perhaps once this war is won, there will be a greater appreciation that the fates of the West and the developing world are intermingled—economically as well as politically. Is a promising New World Order in the making? Or is the old one merely coming undone? As long as such questions hang in the air, it will be hard to invest or plan for the long term.

With Peter Coy in New York, Geri Smith in Mexico City, Michael Shari in Singapore, and bureau reports

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A SHOCK TO THE EQUITY CULTURE

It was the currency we paid our entrepreneurs, the way we financed our retirement, the means to corporate mergers, the measure of individual success, the game to win, the essence of our culture—stocks. In the 1990s, the stock market defined America

as never before. We lived in an equity culture in which we increasingly looked to the stock market to provide not only our immediate prosperity but also our social safety net—once solely the responsibility of big government and big corporations. Now the foundation of this equity culture, the valuations of the stocks themselves, is being severely shaken. With stocks plunging further in a week than anytime since the Depression, consumer net wealth dropping faster than anytime in history, profits falling at a record rate, and chief executives wondering if their current business models ma

LOST FOOTING

Today, growth and earnings are hard to forecast and stocks impossible to value. How can risk be factored in when the outcome of the effort to make the country secure again is itself unknown?

any more, it is no wonder that we all feel so betrayed by a stock market. What has changed in so short a time? In a word, risk. The soaring stock market of the past decade was based on a low-risk, high-certainty economy that made double-digit earnings growth rates possible as far as the eye could see. Lofty price-earnings ratios reflected a remarkable optimism about the future. After all, the U.S. had won the cold war, and there was no serious foreign threat to security. The homegrown high-tech revolution had left Japan and other competitors in the dust, tempered the business cycle, and opened new vistas for higher productivity and growth. Globalization expanded markets and sources of capital and labor. The federal budget went from deficit to surplus. Unemployment fears vanished as companies fought for employees. Cities recovered their vibrancy. Confidence was exceptionally high, and Americans were comfortable taking more chances in the stock market. Academics told them that the risk premium for stocks long term was higher than bonds. So investors accepted sky-high p-e's, lifted-up bottom lines, and some strange business plans—because who really knew what was possible? It was a time of opportunity, a time to place bets. And they paid off: A virtuous cycle of rising stocks, cheap capital, more investment, higher productivity, greater growth, and still higher unit prices generated enormous prosperity in the U.S., Asia, Europe, and around the globe. Two assumptions turned out to be erroneous, however.

The high-tech revolution did not eliminate business-cycle risk, as many had believed. As *BusinessWeek* pointed out in "The new business cycle" (Cover Story, Mar. 31, 1997), technology made the cycle more volatile, not less. Over-investment in telecom and other tech industries led to a sudden and severe collapse in profits throughout the sector. Tech CEOs, who believed in their own control over the business cycle, went into shock. Chief executives who prided themselves on being able to see far into the future were forced to concede that they had "no visibility" for the quarter ahead.

Then, at this very point of economic weakness and vulnerability, the U.S.—and the world—became unsafe again. The attacks on the World Trade Center and the Pentagon made our lives uncertain and insecure. Geopolitics returned from the grave of the cold war to trump globalization and challenge the open flow of goods, capital, and labor essential to the high growth and multiples of a buoyant stock market.

That is where America and the world stands today. No one knows what stocks are worth just now. No one knows what valuation rules to apply. The new economics of uncertainty makes growth and earnings hard to forecast, and proper p-e ratios unknown. Only one thing is clear: The nature and size of risk have changed, and we are recalibrating them in everything we do. Most important, a political/military risk factor must now be incorporated into the economy's expected performance. For the first time in decades, consumer confidence and business investment depend in large part on the execution of a complex international operation to destroy terrorism and make the country secure again. It could take months. It could take years. And no amount of patriotic talk can negate this uncertainty. That's why the stock market has lost its footing in recent weeks.

BEST CASE, WORST CASE. There are best-case and worst-case scenarios. The Bush Administration puts together an international antiterrorist coalition and eliminates Osama bin Laden rather quickly. The U.S. doesn't sustain any more terrorist attacks. Confidence returns. Big-government spending and low interest rates spur the economy, and growth returns by mid-2002 as the business cycle rights itself. The extra cost to the economy to secure the country remains modest. Higher military research and development spurs innovation. (The Internet, after all, is a child of the cold war.) Earnings potential rises again, not to the halcyon levels of the '90s perhaps, but to a significant degree. Stocks surge.

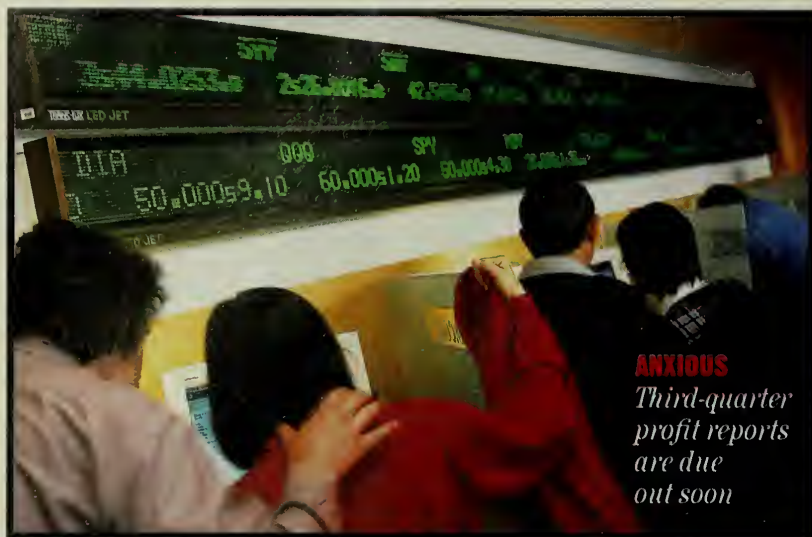
The worst-case scenario is quagmire. The armed forces can't find bin Laden, or they do but then go after Saddam Hussein and get bogged down in a long war. Terrorists attack American cities, sapping consumer and business confidence. The cost to the economy to secure the country becomes heavy. Growth returns but is slow for years. Earnings growth shrinks to low single digits, and valuations tumble. The stock market languishes.

There are, of course, other scenarios. Both Britain and Israel have had vibrant economies and strong stock markets through years of terrorism. People can compartmentalize their lives and go on.

There is even a possibility that the battle against terrorism could actually improve the geopolitics of the world—tying Russia closer to the U.S., bringing Iran back to Western market democracy, opening statist Egypt to global markets. An end to terrorism would again raise investors' appetite for risk and raise growth prospects that support healthy p-e's. The stock market would flourish.

Which scenario plays out won't become clear until the mammoth U.S. effort to secure itself gathers momentum. At stake are the lives of many and the prosperity of all.

Nussbaum is Editorial Page Editor.



WALL STREET

INVESTORS WITHOUT A COMPASS

Stock-valuation models point in different directions

How bad will the stock market get? That's the \$10.8 trillion question—roughly the market value of corporate America—two weeks

after the terrorists struck at the heart of Wall Street and American capitalism. In the first five days after trading resumed, the Dow Jones industrial average suffered its biggest weekly percentage decline since 1933, falling 14.3%, to 8236. Over that weekend, Wall Street investment strategists started talking up the bargains created by the torrent of selling. And by Sept. 26, the Dow had recouped to 8567.

So far so good—but don't breathe too easily yet. Even if the worst of the sell-offs is past, the stock market is in for some wild times, with sudden swift movements and heightened day-to-day price volatility. The best guess is a Dow stuck in the 8000s for some time.

These next few weeks would have been a troublesome period even without the events of Sept. 11. Now, with America's frightening vulnerability to terrorism so blatantly exposed—and recess-

sion far more likely—investor confidence will be sorely tested. The uncertainty raised by the military, political, and diplomatic maneuvers can't be quantified into a stock-valuation model.

Several such models are signaling that stocks are significantly undervalued. The so-called "Fed" model, which relates earnings and interest rates,

shows 13% undervaluation. Some dividend-discount models, which also incorporate earnings growth and risk, point to 15% undervaluation.

But those models rely on forecasts in which investors have some confidence and that is in short supply. Consumer confidence, while not the same as investor confidence, is a good proxy, since 84 million people own stock, directly through mutual funds. On Sept. 25, the Conference Board reported that consumer confidence plummeted in August by the largest amount since the Persian Gulf War buildup in 1990. "I'm concerned investors will become more pessimistic than economic conditions justify," says Jeremy J. Siegel, author of *Stocks for the Long Run* and a finance professor at the University of Pennsylvania's Wharton School.

LOW EXPECTATIONS. Of issues that can be weighed and measured, earnings are front and center. The first profit reports for the third quarter will come out in early October. Investor expectations are already low—earnings on the S&P 500 companies are forecast to be down 28% from last year's third quarter (page 38). Still, the question is: Are the estimates low enough? Worse-than-expected news and, more important, what companies have to say about the coming quarter could also further hit stock prices.

The calendar raises the anxiety level, as well. October is associated with market crashes—1987 and 1929 are most notable, but the 1997 and 1989 sell-offs were nasty, too. Then there are book-keeping issues. Mutual funds are required to make distributions by Dec. 31, and as a result, a lot of portfolio trading takes place in October. Any rallies that do get under way could end in selling from the fund managers.

CLOUDED CRYSTAL BALLS

What some common valuation models used by Wall Street show:

FED MODEL

Calculates an "earnings yield" by dividing expected company earnings by the S&P 500 index and comparing that to the yield of 10-year Treasury notes.

MARKET IS 13% UNDERVALUED

DIVIDEND-DISCOUNT MODEL

More elaborate version of the Fed model. Analysts create proprietary formulas and plug in multiple factors, including their estimates of gross domestic product and earnings growth.

MARKET IS 15% UNDERVALUED

PRICE-TO-BOOK

Compares total market value of companies with the net worth reported on their balance sheets.

MARKET IS 30% TO 40% OVERVALUED

P-E RATIO

Divides stock prices by reported or forecast earnings. Resulting number implies how many years investors must wait before the company earns what they paid for its stock.

MARKET IS 25% OVERVALUED, BASED ON AN AVERAGE P-E OF 15 OVER THE PAST 70 YEARS

Data: BusinessWeek, Standard & Poor's Corp., Smithers & Co., Vardem.com

er to salvage what little profit they can. If fund investors start redeeming en masse—and so far, they're not—that will step up the selling even more. Individuals have until Dec. 31 to sell stocks in order to take losses on their 2001 tax returns.

ALTERED PROFITS. Still, there are countervailing forces. The Federal Reserve has been aggressively cutting short-term interest rates since January, and it takes about a year to start lifting the economy. The stock market typically anticipates the recovery three to six months ahead of time. So if the rate cuts work,

stocks should start to show it soon.

There are other pluses, too. Energy prices, which rocketed earlier this year, are rapidly falling. Since Sept. 17, crude oil has plunged 22%. That will help battered profit margins and free up some cash for consumer spending.

Finally, the bear market—the second-worst in 50 years—could be viewed as positive. The 36.8% decline in the S&P 500 since its March, 2000, peak has wiped out lots of speculative excesses. Even before Sept. 11, margin debt had come down to early 1999 levels, and more debt has been extinguished since then.

What's more, as the quarter ended, the S&P 500 was headed toward its sixth double-digit third-quarter loss in the past 50 years. Each time before, says Arnold Kaufman, editor of Standard & Poor's *Outlook*, the market has rebounded an average of 10% in the following quarter.

That may not happen this time. After all, investors are facing a peril without precedent that will temper any rebound. What's shaping up is an angst-ridden market stuck in a trading range.

By Jeffrey M. Laderman, with David Henry, in New York

COMMENTARY

By Rich Miller and Laura Cohn

EVEN 'FREE MONEY' MAY NOT DO THE TRICK

When Federal Reserve Chairman Alan Greenspan gathers his colleagues in the central bank's stately boardroom on Oct. 2, there's no doubt about what they'll do: cut interest rates. The widely expected cut would be the second in two weeks and would lower short-term rates below 3% for the first time since the 1960s. Even more important, it would cut real rates, after adjusting for inflation, to zero. In the world of economics, that's equivalent to free money.

Normally, that sort of financial firepower would be more than enough to repel a recession. But these are not normal times. The Sept. 11 attacks have shaken America's psyche, making the future a lot more uncertain than it was just a few weeks ago. That has led to a fundamental reassessment of risk throughout society. You can see it in half-empty airplanes and the plunge in consumer confidence. But it has also shown up in the financial markets, where stocks have slumped and corporate-bond yields have risen despite the Fed's Sept. 17 rate cut. The financial and emotional fallout from Terror Tuesday will continue to stymie Greenspan's efforts—and rates may go even lower still.

STOCK HIT. For starters, the swoon in stocks has tightened financial conditions considerably since early September, according to a Goldman, Sachs & Co. index. Roughly \$1 trillion worth of wealth has been destroyed by the collapse of the stock market in the wake of the terrorist strikes. That has torn a big hole in investors' pockets and more than offset the stimulus from the Fed. Although stocks bounced up briefly after a week of steep losses, financial conditions are not likely to change much soon.

Despite the Fed's offer of free money, the steep slide on Wall Street has also put the kibosh on initial public offerings—a market that was already reeling from the nose-dive of the Nasdaq. Six companies were forced to scrap or

postpone IPOs after the terrorist attacks, including Continental Airlines' planned spin-off of Continental Express.

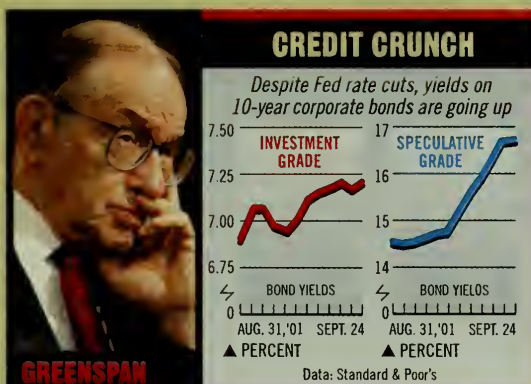
Financing has also gotten tougher in the \$1.8 trillion corporate-bond market. After soaring earlier in September, debt issuance by Corporate America has slowed to a trickle. Deutsche Bank Securities Inc. strategist Louise Purtle thinks U.S. companies will end up issuing some \$30 billion in bonds in September, vs. \$80 billion in May. "One of the big problems in our economy is a lack of access to capital," says Keith E. Busse, CEO of Steel Dynamics Inc. in Fort Wayne, Ind. "I don't think bringing interest rates down is going to have a large effect."

BUDGET BUST? Moreover, while the Fed has cut its own rates, fear of falling profits and financial distress has sent long-term corporate-bond yields up rather than down. Only the bluest of blue chips have been spared. The fallout has been most severe in the junk-bond market, where yields have risen nearly two percentage points. Bond yields are also being pushed up by other worries: possible forced selling by insurers to cover claims stemming from the crisis and chatter in Washington

of a budget-busting fiscal package. Greenspan has already cautioned lawmakers against overdoing it, but Congress may not be in a mood to heed the Fed chief.

Instead, lawmakers are listening to their constituents—and what they're hearing isn't good. Consumer confidence suffered its worst drop since 1990 in September, hit by rising unemployment, falling stock prices, and the terrorist attacks. "I don't care how low interest rates go," says David A. Wyss of Standard & Poor's Corp., a unit of The McGraw-Hill Companies. "If people are scared, they won't buy." That's one more reason why this time, free money may not be enough.

Miller and Cohn cover the Fed from Washington.



CORPORATE PROFITS

IT'S ROUGH ALL OVER

Virtually every sector will take a hit in earnings

It's no secret that the terrorist attacks on Sept. 11 devastated airlines, insurers, travel agents, and stockbrokers. But that may be just the beginning. It's becoming increasingly clear that the damage will extend across almost the entire spectrum of U.S. business, from energy and manufacturing to technology, retailing, and autos. Even before the attacks, 2001 was shaping up to be a terrible year for corporate profits. Now, earnings threaten to show "the sharpest drop we've ever seen" in the postwar era, warns David A. Wyss, chief economist for Standard & Poor's Corp.

If Wyss is right, full-year earnings for the S&P 500-stock index could plunge a breathtaking 31% from last year's record levels. And he has plenty of company. The consensus of 16 Wall Street strategists surveyed by First Call/Thomson Financial forecasts that earnings will plunge 28% in the third quarter and 23% in the fourth quarter. That compares with estimated drops of 18% and 9% prior to Sept. 11.

Prospects for corporate earnings, of course, will depend largely on consumers' willingness to spend. On Sept. 25, the Conference Board reported that its consumer confidence index plunged to 97.6 in the wake of the attack, from 114 in August, the lowest reading since 1990. Those numbers are only likely to head lower as corporations further retrench to cut costs. Indeed, Wyss predicts that companies will shed 2 million net jobs in the coming months, or 1.25 million more than he expected prior to Sept. 11. That could drive the unemployment rate to 6.5% by mid-2002, from 4.9% in August.

As long as the downward spiral continues, virtually every industry will be hurt. Some will feel the pain more than others, and a few could skirt by unscathed. But for most, as the economy weakens, it will be nearly impossible to

escape a hit to the bottom line. Indeed, the rest of this year and possibly well into next year are likely to prove deeply sobering for U.S. businesses. Here's the new outlook for several key industries:

TECHNOLOGY



Nowhere had the economy been hurting more than in the tech sector. Spending in the \$450 billion information-technology industry had already slowed well before the attacks. But now, IDC predicts that spending will climb just 3% this year, down from 11% last year and the 6.7% expected for this year prior to Sept. 11. "Hang on, everybody," warns Sun Microsystems Inc. Chairman Scott G. McNealy. "The economy is going to throw us around, and whoever survives the turbulence will be a leader."

The next two quarters will be especially brutal. First Call now estimates that earnings for the tech sector will fall 86% for the third quarter, with an additional 56% drop in the fourth quarter. In part, that's because customers typically lock in sales of expensive items such as computer servers at the end of a quarter. Since Sept. 11, many of those deals have been put on indefinite hold.

As a result, on Sept. 20, data-storage king EMC Corp. was forced to warn that it will no longer meet its goal of \$1.8 billion in third-quarter revenues, its breakeven point. In response, it is trimming 2,400 more jobs, or 10% of its staff. And Oracle Corp. Chief Financial Officer Jeff Henley warned on Sept. 17



PARCHED VALLEY As corporate profits dry up, a tech recovery have been delayed

that he now expects software-licensing revenues to slip as much as 15% in the company's next quarter, nearly twice the drop that was expected before the attacks. "Many companies are going to have a very difficult time," says Henley.

Personal-computer makers had counted on the rollout of Microsoft Corp.'s new operating system, Windows XP, to rev up sales. But now, Charles Wolf, an analyst at Needham & Co., expects shipments to fall 5.6% in the third quarter and 8.1% in the fourth. Previously, he had expected increases for both of those quarters. That will decimate earnings. First Call now pegs a third-quarter earnings drop for computer makers at 56%, with a 29% fall in the fourth. The already struggling semiconductor manufacturers will feel more heat, too: Analysts estimate that their earnings will be off 104% in the third quarter and an additional 95% in the fourth. Even software, which had held up pretty well despite the slowing economy, now faces a hit as corporate buyers retrench.

AUTOS



Since anxious consumers are especially likely to hold off on big-ticket purchases, Morgan Stanley Dean Witter auto analyst Stephen Girsky predicts that car sales will slump to 16.1 million vehicles this year, down



capital spending, hopes for
mid-2002 at the earliest

EARNINGS ESTIMATES FOR THE S&P 500*

THIRD QUARTER, 2001

AS OF SEPT. 10

-18%

AS OF SEPT. 21

-28%

FOURTH QUARTER, 2001

AS OF SEPT. 10

-9%

AS OF SEPT. 21

-23%

* Based on the consensus of
16 Wall Street strategists

Data: First Call/Thomson Financial



EMPTY LOTS To lure buyers, the Big
Three are offering interest-free loans

from 17 million last year and the 16.8 million he expected prior to Sept. 11. And for 2002, he expects sales of just 5.2 million. "The impact...on the U.S. auto sector is devastating," adds Merrill Lynch & Co. analyst John Casesa, who is predicting that all three auto giants will likely have to cut their dividends.

To get shoppers back into showrooms, the Big Three are all offering interest-free loans on most 2002 model cars and trucks. But because such expensive incentives only compound their profitability problems, "these companies will have to move faster and more aggressively to restructure their businesses," says Casesa. Ford Motor Co. is now expected to cut even deeper into its workforce. According to First Call, analysts who have updated estimates since Sept. 11 now believe Ford will lose \$274 million in the third quarter. They also estimate that Ford will earn just \$604 million this year, down from \$3.5 billion last year, and less than of half what was expected before the attacks. And estimates for General Motors Corp. now peg earnings at just \$2 billion this year, down from \$5 billion last year.

At Chrysler Group, which cut 26,000 jobs in February, "the turnaround could be in jeopardy," says Deutsche Bank Alex. Brown analyst Rod Lache. Because Chrysler is still losing market share, more layoffs are possible, and its

recovery will almost certainly be delayed.

RETAILING



Fall is typically a season of hope for retailers. Back in early September, industry leaders were betting that sales would gain momentum through the fall, setting the stage for an earnings rebound. But for most retailers, those hopes collapsed along with the Twin Towers. Instead, with consumer confidence plunging, they're bracing for a brutally tough Christmas. On Sept. 20, PricewaterhouseCoopers LLP warned that retail sales will rise just 1.5% in the fourth quarter, just a third of last year's gain and even lower than the 1.8% posted in the 1991 recession. The terrorist attacks "could not have come at a worse time," says Robert Buchanan, a retail analyst at A.G. Edwards & Sons Inc., who last week slashed third-quarter earnings estimates for almost every retailer he covers by an average of 16%. Indeed, nearly all retailers will be down compared with year-ago levels.

Some retailers will fare far worse than others, however, especially upscale stores. "The Bermuda Triangle of retailers for the holidays will be full-service department stores, specialty apparel retailers, and fine jewelry stores," predicts Burt Flickinger III, a consul-

tant at Reach Marketing in Westport, Conn. He expects double-digit earnings declines at such retailers as Gap, Abercrombie & Fitch, and Saks. Conversely, analyst Buchanan has reduced estimates for Wal-Mart Stores Inc. just 3% because it sells so many basics that people must buy. Similarly, home-improvement retailers such as Home Depot Inc. and Lowes Corp. may also be well positioned as people stick close to home.

MANUFACTURING



Another sector that was well into a slowdown before Sept. 11, manufacturing is also bracing for deeper trouble. Boeing Co., of course, is among the hardest hit: Several analysts expect its earnings to fall 35% next year. "Never in our wildest dreams did we believe we'd be in this kind of situation," says Alan R. Mulally, CEO of Boeing Commercial Airplane. "This is absolutely gut-wrenching."

Scores of other manufacturers are also hurting. "No one wants to make a decision" on major capital projects, says S&P's Wyss, who predicts that spending on business equipment will fall 2% more next year from this year's levels instead of rising 6% to 7% as he had expected prior to Sept. 11. As a result, "we expect slower earnings across the board into mid-2002," says David S. MacGregor,

managing director at MidWest Research. On Sept. 26, UBS Warburg analyst David Bleustein cut his 2002 earnings forecasts for all of the bellwether heavy manufacturers, including Caterpillar, Deere, and Ingersoll-Rand. And the mood in steel is pitch-black. "This industry is devastated," says Keith F. Busse, CEO of Steel Dynamics, "and there could be a lot of pain and agony ahead."

ENERGY



The energy industry has also seen its prospects take a dramatic dive. With a recession expected to trim worldwide oil demand 1% next year, crude, gasoline, and other energy prices have been plummeting. And with OPEC bowing to U.S. pressure to not cut production at its Sept. 26 meeting, analysts expect earnings to fall in

the second half of the year to at least 20%. Conoco Inc. and Kerr-McGee Corp. have already issued third-quarter earnings warnings. And Apache Corp. is pledging to reduce its drilling activity in order to cut costs. "This is not a good thing for anybody's economy," says Unocal Corp. President Timothy Ling.

HEALTH CARE



Health care is one of the rare industries that could continue to prosper. "People still get sick and need to take drugs," says Stephen M. Scala, a pharmaceutical analyst at SG Cowen Securities Corp., who adds: "I haven't changed a single earnings estimate since Sept. 11." Scala still expects drug companies to see earnings increases of 14% in the fourth quarter.

For all the near-term gloom, most

analysts expect earnings to begin rebounding by the second half of next year. Indeed, heavier-than-expected federal spending and deeper interest-rate cuts could provide a bigger stimulative kick. And even in the hardest-hit industries, restructuring could set the stage for vigorous recovery. Among insurers, for example, those that can weather the downturn "will face less competition and have tremendous pricing power," says Jon Laupheimer, director of research for MFS Investment Management in Boston.

That's a comforting thought for investors. But first, companies—and thousands of their soon-to-be-former employees—must endure enormous pain.

By William C. Symonds in Boston and Ira Sager in New York, with Joan Muller in Detroit, Louise Lee in San Mateo, Calif., and Christopher Palmer in Los Angeles

WINDOWS XP: WHEN HYPE GETS TOO HYPER

It would be hard to find a hype machine more finely tuned than that of Microsoft Corp. For months, the hoopla surrounding its soon-to-be-released operating system, Windows XP, was building to a crescendo for the launch on Oct. 25. Microsoft planned a festival-like kickoff in New York's Times Square. And it planned to shell out \$200 million to advertise Windows XP, with partners kicking in an additional \$800 million. The tagline for the ads: "Prepare to fly."

No surprise that the ad campaign has been shelved in the wake of the Twin Towers attacks. Yet Microsoft is forging ahead with its scheduled Big Apple launch, albeit with the hype toned down. Indeed, the attacks have placed Microsoft in the awkward position of needing to push its most important product launch in years but doing so in a way that does not appear crass or insensitive. "You want to heed the message that President Bush is saying about getting back to business. But people have felt this tremendous loss," says Microsoft Mar-



keting Vice-President Mich Matthews.

It's a marketing mind-bender that confronts not just Microsoft, of course. Across the country, companies of all stripes are attempting to delicately rejigger product launches and marketing strategies in a changed world. It's one in which the usual hard sells, irony-laden pitches, and even humor can appear to be in bad taste. Indeed, one of

Microsoft's ads had PC users flying through buildings, which looked eerily similar to attack victims leaping to their deaths from the burning towers. The new ads will feature smiling PC users levitating a few feet off the ground to suggest the freedom and mobility that the earlier ads hoped to convey. And all references to the world flying are gone.

Moreover, Microsoft and the long-suffering PC industry will be hard-pressed to get consumers to pay attention. "How do they make people care? That's the biggest problem," says David Readerman, an analyst with San Francisco-based Thomas

Weisel Partners who downgraded Microsoft shares on Sept. 24.

With the Times Square launch, Microsoft had hoped for an extravaganza that would rival its Windows 95 launch at its Redmond (Wash.) headquarters, which featured a giant tent, amusement park games, and Ferris wheel. But those plans were put on hold after Sept. 11. At first, it was unclear if New York wanted all the analysts, customers, and media hanging around. Now, the launch will proceed at the Marriott Marquis Theater as planned. But Microsoft is revisiting every piece of the event and is considering shelving its now-customary post-event concert.

Even so, XP isn't likely to provide the kick in the pants the PC industry so badly needs to spur consumer sales. Despite offering XP operating systems to customers a full month before the formal kickoff, PC makers say sales remain mired in a slump. And the increased likelihood of recession means corporate sales could also sputter. "It's going to basically twist in the wind for the next three quarters," says International Data Corp. analyst Roger Kay.

Microsoft's elimination of all reference to flying was surely the right thing to do. But the ill-fated ad campaign may not be the only thing that doesn't get off the ground.

By Jay Greene in Seattle

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UP TO 3X FASTER...**

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MANAGEMENT

WHERE LAYOFFS ARE A LAST RESORT

Treating them as unthinkable can have big benefits

Nothing would devastate Southwest Airlines Co.'s arm-around-the-shoulder chairman, Herb Kelleher, more than a layoff. Through jet fuel spikes, recessions, even the Gulf War, Southwest has never in its 30 years downsized a single employee.

Even now. In the days after the attacks, as competitors announced job cuts of 20%, Southwest execs were packed into an emergency command center at their bare-bones Dallas headquarters, guzzling coffee and scheming to cut costs. Growth strategies were scotched. New plane deliveries were delayed. The renovations at headquarters were scrapped. But with \$1 billion in cash and no debt, layoffs never had to be considered. Says CEO James F. Parker: "We are willing to suffer some damage, even to our stock price, to protect the jobs of our people."

Such words would likely make famous job-slashers like Jack Welch and Al Dunlap cringe. But Southwest is a member of the tiny fraternity of contrarian companies that refuse, at least for now, to lay off. What most of the non-downsizers have in common is pristine balance sheets and businesses that aren't battered by the vagaries of technology. Even before the disaster, in the face of the dot-com bust and a declining economy, their policies seemed anachronistic. Now, in the aftermath of a national tragedy that economists say makes a recession and thousands of additional job cuts inevitable, their stances seem almost noble, an old-fashioned antidote to the make-the-numbers-or-else ethos pervading Corporate America.

SNAP BACK. It's not altruism at work. Rather, executives at no-layoff companies argue that maintaining their ranks even in terrible times breeds fierce loyalty, higher productivity, and the innovation needed to enable them to snap back once the economy recovers. Some private companies, such as S.C. Johnson and Pella, have long traditions that date back to the Depression, when workers

washed windows over and over just to stay busy. Others—public companies such as FedEx, Lincoln Electric, AFLAC, Erie Insurance, and Nucor—are relying on creative cost-cutting, particularly in the wake of Sept. 11. At steelmaker Nucor Corp., based in Charlotte, N.C., some plants are on a four-day schedule,

tunes swelled with the dot-com boom, struggling through the worst business climate in its 76-year history. Still, the firm is sticking to its no-layoff rule, announced before the disaster, by axing Town Cars, expense accounts, travel, and partner retreats. "In a time of national crisis, unless your very viability is at issue, like the airlines, layoffs are even less appropriate," says Brobeck Chapman Tower Snow. Still, pressure is mounting from some of the firm's 2,000 partners to pull the policy, though Snow says he would resign first.

The tension at Brobeck and other companies underscores how difficult it will be for some to keep their word. In the 1980s, IBM had to renege on no layoffs after it was blindsided by the revolution in desktops, causing deep resentment among employees. The danger



STANDING FIRM With \$1 billion in cash and no debt, Southwest Airlines didn't even consider layoffs

THE COSTS OF DOWNSIZING VS. THE NO-LAYOFF PAYOFF

Massive layoffs can backfire after taking into account

- Severance and rehiring costs
- Potential lawsuits from aggrieved workers
- Loss of institutional memory and trust in management
- Lack of staffers when the economy rebounds
- Survivors who are risk-averse, paranoid, and political

Companies that avoid downsizing say they get

- A fiercely loyal, more productive workforce
- Higher customer satisfaction
- Readiness to snap back with the economy
- A recruiting edge
- Workers who aren't afraid to innovate, knowing their jobs are safe

Data: BusinessWeek

shaving 20% off the average worker's \$50,000 annual pay. Bonuses of senior executives, which make up 66% of their salaries, have been wiped out, too.

Some newcomers to the policy say they were won over after battling in the brutal war for talent in the late 1990s. The tony San Francisco law firm Brobeck, Phleger & Harrison, whose for-

that those asked to sacrifice in the fire place end up losing their jobs anyway. Even so, say some economists, Corporate America has used layoffs too capriciously. That's why many executives at no-layoff companies are encouraging costcutters to make layoffs the last play they look—instead of the first.

By Michelle Conlin in New York

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TAXATION

WASHINGTON TRIES TO SPELL RELIEF

But the one danger may be too much stimulus

With the economy still reeling from the aftershocks of the Sept. 11 terror attacks on the Pentagon and World Trade Center, once-feuding lawmakers have stood shoulder-to-shoulder behind a new mission: putting the full might of the federal government behind efforts to fight a potentially nasty recession.

The pressure for action is coming from all sides—unions fearing a wave of layoffs, small-business owners, and especially America's corporate chieftains. "So many people have the lid on," says FedEx Chief Executive Fred Smith. "We have to stimulate people to buy." To others, the situation is even more dire. "The objective is to keep Americans working," explains John Dillon, CEO of International Paper.

But getting from those laudable sentiments to concrete action sure isn't proving easy. Already, some in Congress and the Bush Administration have put the brakes on hurry-up attempts to craft a second stimulus package. What they're finding is that, despite the clamor for new tax cuts, many of the ideas don't provide much short-term bang for the buck. "My great fear is that we will do long-term damage to the deficit in a futile effort to stimulate the economy," says Brookings Institute economist William Gale.

Nevertheless, given the "do something" attitude, lawmakers may feel obligated to enact some sort of rescue program—if only as more of a psychological pick-me-up than as actual medicine for a sick economy. But even that prospect

has its critics. "If we are going to war, that's the wrong time to cut taxes," warns David A. Wyss, chief economist at Standard & Poor's. "The best thing to do is fix what needs to be fixed—defense and airport security. That will bring the economy along with it."

But that is a minority view. Odds are strong that Congress will soon provide new tax relief. If a bipartisan deal is to be struck, it will likely include investment incentives backed by Republicans and individual tax cuts favored by Democrats.

MASSIVE STIMULUS. Details won't emerge until after Oct. 1. But at a private session with members of the Senate Finance Committee on Sept. 25, Fed Chairman Alan Greenspan said an additional tax cut of roughly \$50 billion, or 0.5% of gross domestic product, would be about right.

Anything policymakers do now will come on top of the massive stimulus Washington has already pumped into the economy. In May, Congress cut taxes by \$40 billion for this year alone. The Fed has whacked interest rates eight times in nine months, lowering the cost of short-term borrowing by 3.5 percentage points.

And since Sept. 11, Congress and



UNITED Senate Majority Leader

President Bush have only loosened the purse strings further. They've agreed to an additional \$40 billion in emergency spending, as well as \$15 billion to bail out the airlines. The Senate Finance Committee figures up to \$400 billion have been injected into the economy since January, nearly 4% of GDP.

While the Fed is surely going to drop rates further, what will Congress do? The first question lawmakers have to answer is whether to make any new tax cuts permanent or temporary. Some, including Senate Finance Chairman Max Baucus (D-Mont.) and the panel's top Republican, Charles E. Grassley of Iowa, say any cut should phase out after one or two years. In theory, temporary investment incentives provide an even

**HOW
WASHINGTON
CAN REV UP
THE SAGGING
ECONOMY**

STIMULATE INVESTMENT

To spur business investment, some Republicans favor incentives such as investment tax credits or more write-offs for equipment. Others, like economist Lawrence Lindsey, want to cut the corporate income tax. But few companies will invest in equipment if orders remain low.

BOOST CONSUMER DEMAND

Democrats in particular want to cut payroll taxes or give low-income workers a tax rebate to get cash into consumers' pockets. Offering companies a tax credit for hiring could help, too. Still, the fear of layoffs and terrorism could lead consumers to save the extra dollars.

INCREASE SPENDING

Speeding up spending on projects such as roads and buildings is being advocated by various Hill Democrats and Republicans. It would get money into the economy quickly. The problem is, much of the investment would have limited long-term impact.



Lott and Lott have put aside feuds and are working together on the rescue

the corporate tax rate is the best way to put money in business' pocket right away."

However, that plan also has drawbacks. Early cost estimates are in excess of \$700 billion over 10 years, according to Brookings' Gale. And because a cut in the tax rate would reward companies for investments they have already made, it might do little to boost the current economy.

Another initial suggestion—reducing capital-gains taxes—also has troubles. Although it has the support of supply-siders, such as Senate Minority Leader Trent Lott (R-Miss.), it has generated limited enthusiasm elsewhere in Washington. Economists fear a temporary cut in the tax would drive investors to sell stock in what is already a slumping market. "Increasing volatility in the capital markets now is the last thing I want," says Barry Rogstad, president of the American Business Conference, which represents midsize companies.

Many Democrats, including ex-Treasury Secretary Robert E. Rubin, say investment incentives miss the point.

MASSIVE INJECTION
Up to \$400 billion
has already been

pumped into the economy this year,
the Senate Finance Committee says

ter kick by pushing companies to buy equipment before the windfall expires. They also keep long-term budgetary constraints under control.

But there's a downside. A temporary tax break might only accelerate investment set to happen anyway. Such borrowing from the future does little to boost long-term growth. "It is just setting the stage for next year's recession," says University of California at Berkeley economist Alan J. Auerbach.

TWO APPROACHES. What options are usually winning support in Washington? Certain industries are already clamoring to put their imprint on any bailout. Tech execs want new incentives aimed at boosting capital spending, noting that investment in computers and telecom gear fell more than 10% in the first half of the year. They suggest two approaches: either provide an investment tax credit or allow faster write-offs of equipment purchases—say, over three years instead of five. Either idea could generate new demand for equipment. And because the tax breaks would benefit only new investment, they would be relatively cost-effective.

But either choice would probably be

hugely expensive. One plan for accelerating business write-offs would cost in excess of \$350 billion over 10 years. Another problem: a lack of customers. "If you think no one is going to buy your stuff, you may not want to invest even if it looks cheaper," says Joel B. Slemrod, who heads the Office of Tax Policy Research at the University of Michigan. Furthermore, because these incentives benefit some manufacturers more than others, some pols are leery of squabbles between industries that come out winners and those that don't.

Meanwhile, top White House economist Lawrence B. Lindsey and others, particularly in the GOP, are considering a different solution: They would like to reduce the corporate tax rate from 35% to 25%. This should boost both profits, and, as aftertax earnings rise, stock prices. Says Kevin A. Hassett, an economist at the American Enterprise Institute: "If you're worried about financial issues, bankruptcy, and layoffs, cutting

They insist the real problem is a collapse in consumer confidence and spending. The prescription: cutting individual taxes in one of several ways on the table. One would give a rebate to low-income workers who didn't get checks from the May tax bill. Another would cut payroll taxes by one or two percentage points, or provide an income tax credit for those taxes.

Each idea would put \$10 billion to \$20 billion into consumers' pockets. But some economists doubt whether much of that cash would be spent due to fears of layoffs, sagging stocks, and worries about personal safety. Still, a consumer-oriented tax cut will be part of a bipartisan bill, since it is the price of getting Democrats on board.

While the pressure to act is great, such steps aren't immediately guaranteed. Treasury Secretary Paul H. O'Neill and others are urging Congress to go slow. And some economists say Washington's best course is to do nothing.

ing. With so much stimulus already chugging through the economy, they're already seeing interest rates rise as the bond market begins to worry about massive new Treasury borrowing. If that continues, it could offset any stimulus. According to Gale, a 0.75 percentage-point boost in rates would elim-

inate the benefits of a big tax cut. That's one reason why Greenspan wants a relatively small fiscal stimulus package.

Many economists have an even bigger fear: that the events of Sept. 11 administered such a shock to the national psyche that no standard stimulus will quick-

ly get growth back on track. "How do we restore Americans' sense of confidence?" asks Rogstad of the American Business Conference. The answer may be a good deal more complicated than lowering taxes or slashing rates further.

By Howard Gleckman, with Lorraine Woellert and Rich Miller, in Washington

COMMENTARY

By Richard S. Dunham

GOT A BILL TO PUSH? WRAP IT IN THE FLAG

At first blush, Attorney General John Ashcroft appeared to be reacting forcefully to the threat of terrorists among us when he called on Congress to endorse new intrusions into personal privacy. "The American people do not have the luxury of unlimited time in erecting the necessary defenses to future terrorist acts," he told the Senate Judiciary Committee on Sept. 25.

An unusual coalition of conservatives and liberals sees another agenda at work, however. By piggybacking controversial wiretapping and preventive-detention provisions on top of a dozen antiterrorist measures,

Ashcroft is trying to use public ire to push proposals that lawmakers have long resisted. Or so say groups from the American Conservative Union to the American Civil Liberties Union. "The Justice Dept. threw together its entire wish list of the last 10 years," says

conservative activist Grover G. Norquist. "To take advantage of a situation like this is outrageous."

PUSHING "FAST TRACK." In post-terror Washington, one person's outrage is another person's window of opportunity. Old agendas are being wrapped in the flag as everyone from Cabinet Secretaries to corporate lobbyists tries to capitalize on the public mood. Usually the pitch solemnly proclaims that one proposal or another is needed to protect the country from terrorism or help the sagging economy rebound. All within the bounds of good taste, of course.

Business groups, for example, say that Presidential trade-promotion authority (long known as "fast track") is now vital to help President Bush reward partners in his multinational

coalition against terrorism. Steelmakers say they need protection not just to combat unfair foreign competition but because a healthy steel industry is crucial to national defense.

That's just the beginning. Big Oil argues that drilling in the Arctic National Wildlife Refuge would help

NEW PITCH Arctic drilling, Big Oil says, will bolster security

protect energy security, and on Sept. 25, Senator James M. Inhofe (R-Okla.) unsuccessfully tried to attach an open-the-ANWR proposal to pending defense legislation. Amtrak, meanwhile, is asking for millions to help it cope with a flood of new travelers and new security challenges.

"This crisis is being used as a rationale for doing all sorts of foolish things," says Cato Institute President William A. Niskanen. And even good ideas are being repackaged in patriotic wrapping. When it comes to the Pentagon budget, says Representative Mac Thornberry (R-Tex.), "Whatever's in the pipeline is now 'the key to fighting terrorism.'"

While some lobbyists aggressively push the disaster angle, most in the business community don't want to seem as though they're cashing in on the tragedy. Indeed, insurance industry representatives told Bush on Sept. 21 that they didn't want an airline-type bailout. Still, insurers say they'd like to create a partnership with the government to share the risks in case of future acts of domestic terrorism. "To us, there is a bright line between value-added help to the victims and our companies—and opportunism," says Phil Anderson, senior vice-president of the American

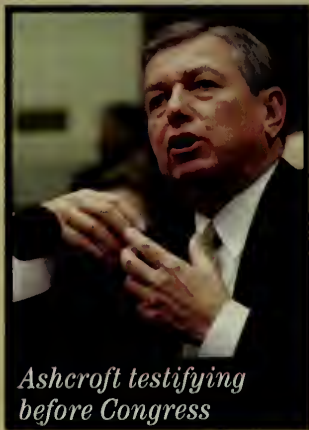
Council of Life Insurers. "We're making sure we stay damn far behind that line."

The same can be said for the hospitality industry, which has been trying for years to restore full tax deductibility for business meals. "We've been very reluctant to engage in a lobbying strategy that plays off the [Sept. 11] events," says Lee Culpepper of the National Restaurant Assn. Still, lawmakers

"know what our agenda is and they can connect the dots as they see fit."

With Washington in a bailout frenzy, lobbyists must decide whether to be crass—or be left behind. "If the government's going to start handing out checks, someone will think he's not doing his job if he doesn't get in line," worries U.S. Chamber of Commerce Executive Vice-President R. Bruce Josten. Trouble is, the line could quickly become endless.

With Amy Borrus in Washington



Ashcroft testifying before Congress



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POWER BROKERS

BOB RUBIN: OUT OF OFFICE BUT IN THE LOOP

The economic crisis brings him back to Washington

He was there on Sept. 19, when congressional leaders clamoring for an emergency rescue package for the reeling U.S. economy huddled with Federal Reserve Chairman Alan Greenspan and Treasury Secretary Paul H. O'Neill. He turned up again on Sept. 25, when the Fed chief delivered his latest damage assessment to a closed-door meeting of the Senate Finance Committee. Who is that tall, angular man in the dark suit? None other than former Treasury Secretary Robert E. Rubin. Although his day job is chairman of the executive committee at Citigroup Inc., his sideline seems increasingly to be as shadow Treasury Secretary for wary Hill Democrats.

Why wary? With President Bush's popularity sky-high in the wake of the Sept. 11 terror attacks, Democratic congressional leaders want to make sure that a raft of Republican tax ideas—from slashing capital-gains rates to permanently trimming corporate taxes—don't get rammed through in the feverish mood of national crisis. The unflappable Rubin, a critic of George W. Bush's first round of big tax cuts, is viewed as just the sage presence the party needs to argue for progressive-style tax relief. Democrats would prefer to focus on temporary aid that targets low- and moderate-income groups over top-tier taxpayers and corporate interests.

Over the past few months, Rubin has given occasional pol-

icy briefings to Democratic members of the House Ways & Means Committee and other party groups. "Bob likes to keep his hand in," says an associate. Then came Terror Tuesday and its wrenching economic shock. With terrified lawmakers issuing frenzied calls for up to \$180 billion in new spending and tax stimulus, both House Speaker J. Dennis Hastert (R-Ill.) and Minority Leader Richard A. Gephardt (D-Mo.) thought it was time to cool things down and bring in the wise men. Thus it was no surprise when Rubin was asked to come along when the first bipartisan Hill group met with Greenspan to discuss economic options.

In the initial talks, Rubin aligned him-

self with Greenspan and O'Neill by urging lawmakers to wait a few weeks before enacting any rescue plan. That stopped the tax-cut express cold, buying valuable time for the White House to assess the economy's prospects more deliberately. Afterward, O'Neill called Rubin's role "wonderful," adding that "we need to take advantage of every smart mind that we can bring to bear on the problems." Citigroup Chairman and CEO Sandy Weill thinks O'Neill and Rubin can together help rebuild public confidence. "I just wish [Rubin] would spend more time in our office," he jokes.

PURCHASING POWER. With the stock market showing signs of stabilizing two weeks after the terror strike, policymakers now are trying to assemble an economic response package that could ease growth from the \$55 billion in emergency spending already in the pipeline to upwards of \$100 billion. Rubin's role now will be to back up Democratic leaders who want the bulk of any new tax break to be temporary and to focus on stimulating consumer spending. "He thinks there's more to be done on the demand side than the supply side," says Senator Charles E. Grassley (R-Iowa), ranking Republican on the Senate Finance panel.

Rubin typically has been cloaked in silence about his participation in the ongoing economic dialogue. He did not respond to calls from *BusinessWeek* for comment. But sources close to the discussions say that Democrats view him as a crucial element of a consensus plan to help the economy fight off what many forecasters now say is a bona fide recession.

And that in itself is a bit ironic. In 1993, Rubin was vilified by the Democratic Left for ensnaring Bill Clinton in a "bond-market strategy" that elevated deficit reduction over popular interest groups' calls for new social spending. Ultimately, Rubin's prediction of the bonanza entailed by lower interest rates silenced the opposition and won him a place in Democrats' pantheon of economic stars. That, more than anything else, explains why Citizen Bob has been drafted for his latest economic rescue mission.

By Lee Walczak, in
Lorraine Woellert,
Washington, and Heath
Timmons in New York

Jokes Citigroup boss
Sandy Weill: "I just
wish [Rubin] would
spend more time in
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OIL

WHY OPEC CAN'T HALT THE PRICE SLIDE

As demand falls, the U.S. crisis rules out a cut in output



NO WIGGLE ROOM
Saudi Oil Minister Naimi can't afford to oppose Bush's war on terrorism. Neither can Prince Abdullah

On the surface at least, the ambience at the OPEC meeting that began in Vienna on Sept. 26 was much the same as usual. Reporters lounged in hotel lobbies, ready to waylay ministers. Upstairs, OPEC delegates conferred over grilled marlin steaks and bottles of earthy shiraz. But behind the routine, there was a sense that OPEC may again be losing its grip on the oil market.

Although prices surged in the hours following the attack on the Twin Towers, they have plummeted in recent days by about 30%, to \$21 per barrel. Traders suddenly are less worried about supply problems. They fear that demand could drop and that OPEC may be unable to respond in its usual fashion with cutbacks. "There is no question that the events of Sept. 11 have caused some definite impact on the market," says Ali Naimi, Saudi Arabia's Minister of Petroleum & Minerals. "Now, the market believes demand is going down as a result of these events."

To be sure, the likelihood of war in

the days ahead and its effect on oil prices is unpredictable, particularly if a major producer such as Iraq gets hit. But unless the conflict causes a price spike, Naimi and his colleagues, including Saudi Crown Prince Abdullah, are in a bind. Falling growth will probably sap demand for the cartel's crude. Until now, OPEC might have responded by announcing cuts in production. To do so today, though, would put OPEC on the wrong side of the Bush Administration's war on terrorism. Case in point: Although Naimi bristles at the suggestion

that he is under pressure from the U.S.—and he insists that the kingdom is observing its production ceiling—the Saudis do seem to be temporarily softening their position on price. "We are on the edge of [a fundamental shift in the oil market]," says a senior executive at a major oil company.

As a result, OPEC may be forced to accept a price far below the rough \$28 per barrel that Naimi has been trying to defend. Indeed, prices could tumble out of control if global economic conditions worsen. "The question is whether they can avoid \$14-per-barrel oil," says Roger Diwan, an analyst at Washington energy consultant Petroleum Finance Co. (PFC).

Adding to the heat on the Saudis to decrease prices is a growing conviction in the kingdom and in Washington that the Saudis bear some responsibility for the Sept. 11 events. Not only were a substantial number of the hijackers Saudi, but Saudi sources admit that funding Islamic extremist organizations such as Osama bin Laden's has come from people in the kingdom. "The Saudi government let the situation get out of control," says Nawaf Obaid, a Saudi oil analyst.

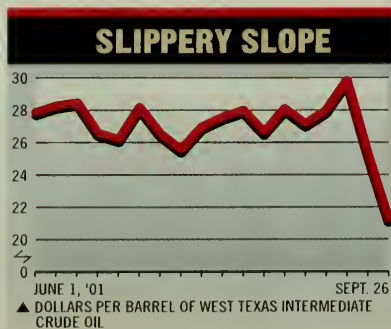
EROSION. In the longer term, much depends on whether the key alliance—OPEC—involving Saudi Arabia, Iran, and Venezuela—can survive the strains of the coming months. A major element in keeping prices near \$30 for the past two years has been Prince Abdullah's decision to placate OPEC price hawks supporting production cuts—at the expense of the U.S.

Already, that policy is being eroded. Although the oil cartel was supposed to cut its production by 1 million barrels per day in September, OPEC members are collectively producing approximately 800,000 barrels a day above the agreed ceiling. "Positive cheating of the rule," says Peter A. Gignoux, head of the oil-trading desk at Salomon Smith Barney in London.

The wild card is that it is difficult to know how much demand will drop. Currently, world supply is outstripping demand by 1.5 million barrels a day. If that imbalance continues for months, stocks would build up and depress prices even more.

Most OPEC countries can afford to live up with lower prices for a while. Saudi Arabia, Iran, Venezuela, the United Arab Emirates, and Kuwait have more than \$500 billion in reserves combining figures consultant PFC. But they'd better conserve their savings. Much is uncertain, and the second coming of OPEC at the start of the 21st century may well be over.

By Stanley Reed in Vienna





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EUROPE

THE FALLOUT IN EUROPE

America's deepening woes are spreading across the Atlantic

It may be a measure of the times that sticking to a business plan can seem like an act of patriotism. You can almost hear a stirring march as Ryanair, the Irish budget airline, charges ahead with plans to acquire eight new planes by March, while negotiating the purchase of 50 more. "People are still traveling," says CEO Michael O'Leary, who, in contrast to other airline chiefs, reports no drop in bookings.

Brave words. But can stubborn optimism protect Europe from the economic and political turmoil that has followed the Sept. 11 terrorist attack? Not likely. Just look at what happened in one short week. British Airways is cutting 7,000 jobs, one-eighth of its staff. Volkswagen scheduled week-long shutdowns at its two main factories in Germany. Designers even canceled all parties at the fall fashion shows in Milan.

Europe's economy was slowing even before the assault on the U.S. Now it could be heading into recession. Germany is likely to be hardest hit, since it has the biggest exposure to the U.S. Earnings at German auto maker DaimlerChrysler, for example, are expected to fall more than 70% this year, thanks to slumping sales at its Chrysler Group unit. "For the first time, all the European economies are moving in the same, negative direction. This quarter and the next quarter will not be good ones," says Klaus Zumwinkel, CEO of Deutsche Post World Net.

For most of the year, many European leaders and economists argued that Europe would weather the storm that has pummeled the U.S. and Asia, since foreign trade accounts for less than 20% of the euro

zone's economy. Besides, they thought, tax cuts in Germany, France, and Italy would drive domestic demand forward. Following the attacks, however, economists have halved their forecast for euro-zone gross domestic product growth in 2002, to 1.1%. UBS Warburg now expects zero growth in the third quarter of 2000 and -0.2% in the fourth quarter—for all intents and purposes a recession. Many investors are even more pessimistic. "Nobody really believes earnings forecasts or valuation numbers," says George Hodgson, European equity strategist at London's ABN Amro Holding. **LINKED FATES.** There's a lesson here about the flip side of globalization. As America's economy took off in the 1990s, Europe's multinationals wanted to cash in on the boom. So companies from Alcatel to Vivendi to Deutsche Bank snapped up U.S. companies. The result: Businesses such as Munich-based Siemens rely on U.S. operations for nearly 25% of sales. Now, U.S. sales of Siemens products such as auto parts

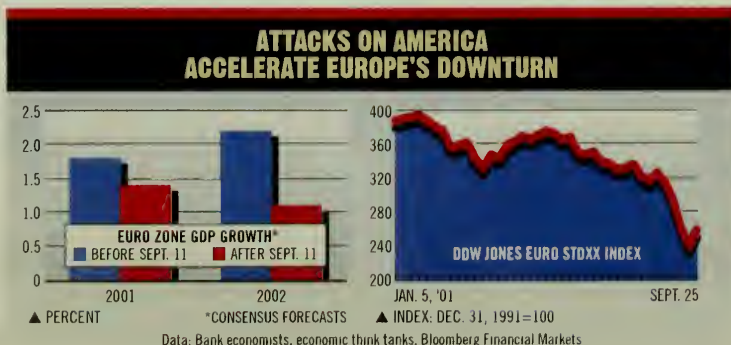
and lighting are suffering. So if the U.S. sinks into a recession, the damage for the Europeans will increase.

Since Sept. 11, companies have begun canceling or delaying investments, cutting workforces, or scrambling for capital. The wave of bad news is sure to hit household spending. "The consumer was already in a fragile situation, so this looks very dangerous," says Lorenzo Codogno, head of euro-zone economics at Bank of America in London. The tension is heightened by the upcoming introduction, on Jan. 1, of euro notes and coins. It's not exactly the perfect moment to ask Europeans to give up their familiar deutsche marks, francs, and lira.

The glum mood has sharply diminished the appetite for risk. In Berkshire, England, backers of a telecom startup called Artaurus suddenly withdrew a promised \$4.3 million in first round funding. Initial public offerings already at a trickle, will take that much longer to recover. European Aeronautics

Defense & Space (EADS), the maker of Airbus planes, canceled plans to boost production capacity. Saab Co-Chief Executive Officer Philippe Camu said, "Frankly speaking, nobody knows exactly what will happen."

At least falling inflation gives the European Central Bank leeway to cut interest rates. Some analysts predict an





DEPARTMENT STORE IN PARIS "The consumer was already in a fragile situation," says one economist

as much as 150 basis points, to 2.25%. Such cuts could relieve the pressure on Europe's indebted telecom companies by lowering the cost of capital. A cut of 150 basis points in the next year would add \$420 million to France Télécom's bottom line, according to study by Dresdner Eintracht Wasserstein.

STERILITY PLAN. Yet the cuts probably won't be accompanied by big government spending. Policymakers don't want to stray too far from the fiscal prudence they adopted when creating a common currency. At a dinner with German executives on Sept. 24, Chancellor Gerhard Schröder rejected suggestions that the government speed tax cuts or subsidize ailing industries such as airlines, according to several participants.

The coming pain won't be spread evenly. The obvious victims are airlines, aircraft makers, and their suppliers. Makers of luxury goods are nervous, too. "It

SAFETY FIRST

The glum mood has sharply cut the appetite for risk

is too early to know what the consequences might be in terms of sales," says Francesco Trapani, CEO of luxury jeweler Bulgari. Investors seem to have made up their minds: Bulgari shares have plunged more than 30% since the bombings.

Who will escape? Chiefly companies that make things people can't do without, such as pharmaceuticals and food. Banks, too, could emerge

relatively unscathed. "People will continue to need banking services," says Keith R. Whitson, CEO of HSBC Holdings PLC in London. Some high-tech companies may profit if they offer cost-cutting tools. "In Europe, we grew our business 10% last quarter. I remain confident," says Sergio Giacometto, executive vice-president for Europe, the Middle East, and Asia at software maker Oracle Corp.

A sharper-than-expected downturn will offer opportunities for predators. Frankfurt-based MG Technologies, the engineering and chemicals business, is trading be-

low book value. After a 60% share-price decline this year, the once-mighty conglomerate has a market capitalization of less than \$1 billion—an invitation to corporate raiders. Already under attack is FAG Kugelfischer, a maker of ball bearings. In a hostile bid, rival INA Holding has offered FAG shareholders a 50% premium on the company's battered shares. As slumping stock markets create bargains, the trend is likely to accelerate. "We are looking for opportunities," says Deutsche Post's Zumwinkel, who has already bought dozens of smaller distribution and freight companies. "Asset prices worldwide are down, and I mean ridiculously down."

Share prices could slump even more when the shooting starts. "Everyone is waiting to see what's going to happen in Afghanistan," says Mario Maselli, president of Emmetex, a textile maker that employs 400 people in Prato, Italy. For now, Maselli has put on ice plans to expand capacity by 15%. Unfortunately, that's just the kind of microeconomic decision that, repeated a thousand times, spells a nasty downturn.

By Jack Ewing in Frankfurt, with David Fairclough in Liege, Kerry Capell in London, and bureau reports

ASIA

TRAPPED IN THE TORNADO

Recession in the U.S. could clobber Asia's economies

In early September, Nintendo Co. was gearing up for the Japanese launch of GameCube, its first console in five years. Then came the

Sept. 11 attacks on New York and Washington. Nintendo expected to move 450,000 units on Sept. 14 but wound up selling just 300,000 in three days. Even Japanese consumers, far removed from the terrorist attacks, were too obsessed with the tragic events to splurge on what was billed as one of the hottest new products of the year.

No one can accurately predict the economic fallout in Asia from the attacks. Ditto for the U.S.'s global war on terrorism. But already signs are emerging of what could shape up as the next Asian crisis. "It is quite serious," says Japan's Eisuke Sakakibara, who was finance vice-minister for international affairs during the 1997-98 financial crisis. "Japan was already in recession before the incident, and many other Asia economies were heading into recession as well."

DUD LOANS. The worst-case scenario goes like this: Asian exports, already weak in a region that depends on shipments to the U.S. to drive growth, start to plummet. Unemployment shoots up. So, too, do bad debts. That puts another burden on banks still shouldering dud loans left from the crisis. Another round of competitive devaluations kicks in. The region's already sputtering corporate and bank reforms are set back even further, as are Asia's hopes of regaining speedy growth rates. Without fast growth, unemployment rises steadily, the region's standard of living drops, and the Asian miracle becomes a memory.



It's not clear that this chain of events will unfold, of course. But the likelihood of a far-reaching crisis has increased. Asia is getting slammed by

the fall in U.S. trade, especially in electronics. U.S.-bound shipments from Korea, Taiwan, Singapore, and Malaysia are expected to be off 20% to 40% from the same period last year in the final quarter. If the bad news continues, says Yukio Shohtoku, managing director of overseas operations at Matsushita Electronic Components Co.,

maker of Panasonic products, "we have to downsize manufacturing Asia, the U.S., and even Japan."

That could be just the beginning. AF Amro Holding economist Eddie Wong has slashed his 2002 growth forecast for most of Asia's economies by two to four percentage points. Except for the sheltered economies of India and China, Wong figures no Asian economy will grow more than 3% next year. Japan will contract about 0.8% this year—but news for the region, which is heavily dependent on trade with the Japanese.

Like their peers around the globe, Asian airlines and hotels are being hit hard. Japan Airlines' profits are likely to be cut drastically this year, from \$596 million to \$33 million. Japanese and Korean car makers are getting rocked by slowing U.S. demand. Honda Motor Co., which earns two-thirds of its profits in the U.S., could suffer most from a prolonged sales drop there. "We may have to trim production," says CEO Hiroyuki Yoshino.

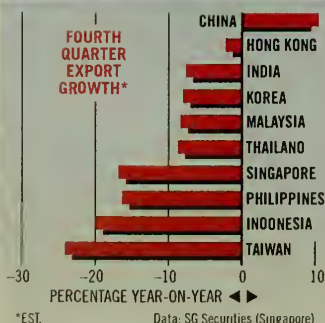
At least Asia has a financial cushion built up from booming exports in 1999 and 2000. Nations have slashed overseas borrowing and built up big stashes of foreign exchange. And governments are unveiling fiscal stimulus packages even as central banks slash interest rates. Singapore has weakened its currency, and South Korea and Taiwan are expected to follow. That should make exports more competitive when demand returns.

FIRST STEP. At the same time, the crisis could provide Japan's Prime Minister Junichiro Koizumi with the political cover to move through reforms. Already, the Bank of Japan has responded to overseas pressure by pumping liquidity into the economy. And Tokyo has proposed a much tougher bank plan than expected. The Financial Services Agency has ordered a fresh round of bank audits and promised the IMF access to bad loans. The betting is that the official acknowledgment of \$145 billion in bad debt is a prelude for Japan's banks will be ratcheted up closer to \$700 billion. Recognizing the true magnitude of the problem is a key first step to fixing the sector.

Last time, Asia's crisis was hoped to be contained. This time, the problem began in the U.S., and Asian executives and policymakers desperately hope America turns around fast. The alternative is too frightening to contemplate.

By Mark L. Clifford in Hong Kong with bureau reports

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RUSSIA

VLADIMIR PUTIN, WASHINGTON'S PAL?

His support for the U.S. could lead to closer ties

When retired General Fyodor I. Ladygin, a former head of Russian military intelligence, first heard reports that U.S. military cargo planes had landed in the former Soviet republic of Uzbekistan in Central Asia, he figured the Americans had cut a sly deal with the Uzbeks without consulting the Russians. No way, Ladygin told *BusinessWeek* on Sept. 24, would Russian President Vladimir V. Putin give a green light to stationing the U.S. military in Russia's own backyard. Wrong prediction, general: In a speech that very evening on national television, Putin voiced support for such deployments to assist the U.S.-led campaign against international terrorism.

Of all the surprising developments the world has witnessed since the attack on the World Trade Center, the sudden rapprochement between Russia and the U.S. is one of the most startling. Russian President Putin—former cold warrior, ex-KGB operative, self-proclaimed restorer of Russian greatness—now wants an alliance with the old arch-enemy, an America that has done little to help Russia economically and sometimes seems intent on stripping it of the little international leverage it has left. Putin is eager to deal with the same White House that has unleashed such attack dogs as Defense Secretary Donald H. Rumsfeld, who has fiercely combatted Moscow's objections to President George W. Bush's missile-defense plan.

QUID PRO QUO. But the war on terrorism suddenly gives Putin extra bargaining chips. Now that the Russians have offered material assistance, the White House is coming under pressure to pay up. In the long run, that could cover everything from granting Russia an expanded role in NATO to U.S. assistance in accelerating Russia's bid to join the World Trade Organization. "What has changed is the potential for the Russian relationship with NATO to grow at a more rapid clip," says a senior U.S. government official in Moscow. Although much remains to be worked out, this

partnership could eventually develop into an alliance that would also ease Russia's opposition to the U.S. missile-defense shield.

Indeed, with the Kremlin on board, there may be a role for Russian technology in creating Europe-wide or American defense-shield systems, U.S. officials say. And the U.S. is now regarding with more sympathy Russia's demand for a security structure to replace the Anti-Ballistic Missile Treaty, which America is bent on exiting. "Putin's announcement of support for the U.S. campaign marks a deep change in the Russia-U.S. agenda," says Andrei A. Piontkovsky, an independent political analyst in Moscow. "Russia may be able to achieve what it hasn't been able to achieve for 300 years in aligning its position with the West."

A complete thaw with Russia? That may still be a stretch, given the existence of hardliners in both camps. But even some progress in improving the relationship would suit Putin's plans. Although he remains wary of America, Putin is making it clear he believes Russia's best hope for a prosperous future is its inclusion in U.S.-led political, economic, and security institutions. His support for the war on terrorism, although falling short of all Russia could do, is winning gratitude in the White House. "Vladimir Putin clearly understands the cold war is over," President Bush declared on Sept. 24. "We can cooperate with a new strategic arrangement."

For now, Putin is carefully delineating the extent of his cooperation with Bush's anti-terrorism campaign. In addition to backing the stationing of American military forces in former Soviet republics in Central Asia, Putin is promising to send arms to the Afghanistan-based Northern Alliance, the main military opposition to the Taliban. Russia also will provide the U.S. with intelligence on Osama bin Laden's terrorist network. And Putin is authorizing military to participate in search-and-rescue operations in Afghanistan—if U.S. pilot is shot down, for example.

Putin is not selling Russia's participation cheap. Sources close to him say he is asking for U.S. security guarantees of assistance if any American attack on Afghanistan triggers a counterattack on Russia by Islamic militants in Central Asia. Current Russian troops in Tajikistan, a former Soviet republic bordering Afghanistan, are on combat alert. What's more, Putin wants the U.S. to give Russia greater say on global security matters, including the anti-terrorism effort. At least, he wants America to declare its political support for Russia's military campaign in separatist Chechnya, where Islamic rebels have received aid from bin Laden's network.





THE ANTI-TERRORISM DEAL

How Putin is Helping...

INTELLIGENCE Will pass on information on the Osama bin Laden network, and may press allies such as Iran and Syria to do the same

LOGISTICS Giving green light for use of bases in Central Asia and agreeing to send troops for rescue operations in combat zone

MILITARY AID Will continue providing weapons and financial aid to Taliban opponents

... What He Wants in Return

CHECHNYA Wants U.S. to acknowledge Russia's military campaign against Chechen rebels as legitimate fight against terrorists

NATO Wants security guarantees for NATO operations near Russia's borders and greater voice in decisions

ECONOMIC BENEFITS Hopes for U.S. backing for fast entry into World Trade Organization

Data: BusinessWeek

as strong backing from investment-thirsty Russian executives

That condition won't be an easy one to fulfill. In the past, the White House has rebuked Russia for its brutal conduct in Chechnya. "We still think Russia is better off with a political solution on Chechnya," says a senior Administration official. However, the U.S. is now willing to assist Russia by helping cut off external sources of financing for Chechen rebels, says the senior U.S. official in Moscow. On the anti-terrorism campaign, the U.S. is likely to consult with Putin but won't give him a veto over operations.

FIRST STEP? If the limited moves envisioned by Putin work out, broader U.S.-Russia cooperation could follow. Moscow could push traditional client states such as Syria and Iran to provide the U.S. with information on bin Laden's network. Moscow might even O.K. the use of Russian troops in combat, says Putin aide Gleb Pavlovsky, despite misgivings in the military after the Soviet Union's failed war in Afghanistan.

America, however, will have a tough time gaining Russia's support for any major strike against Iraq. Russia supplies nearly \$700 million in goods annually to Iraq through the U.N. oil-for-food program, and Russian companies are close to signing \$2.5 billion in contracts there. "Russia will insist that any

actions there are fully justified," says analyst Dmitry A. Danilov at Moscow's Institute of Europe. "Otherwise it would lead to a very negative reaction."

Even though Putin is risking a clash with hardliners over his moves, he has plenty of support from elsewhere in the Russian Establishment. His cooperation with the U.S.-led campaign is welcomed by leading business executives who believe their country will only prosper through greater integration into the global economy. "The era of confrontation between the political systems of NATO and the Soviet Union has ended with the terrorist attacks," says Mikhail Fridman, chairman of Moscow-based conglomerate Alfa Group.

Business leaders are hopeful that a U.S.-Russia warming could yield a quick economic payoff. "The U.S. could push its companies into doing more business in Russia," says Oleg V. Vyugin, a former deputy finance minister and chief economist at Moscow brokerage Troika Dialog. True, total U.S. investment in Russia stands at just \$7 billion—on a par with U.S. investment in Costa Rica. The reason has less to do with political differences than with the perception of would-be investors that Russian business suffers from corporate-governance abuses. Still, Commerce Secretary Don

Evans plans to lead more than a dozen U.S. companies on a trade mission to Moscow in mid-October.

For a long-term struggle against terrorism, Putin will also need to rely on public support. Most ordinary Russians still resent NATO's bombing of ally Serbia in 1999. Some 54% of Russians favor neutrality in the conflict between U.S. and Islamic terrorist opponents, according to a new poll by the All-Russia Public Opinion Center. Still, with a 70% approval rating, Putin can likely bring the citizenry along with almost any anti-terrorism policy he adopts. "The least concern of ordinary Russians is NATO expansion and missile defense," says Yuri Schekochikhin, deputy chairman of the parliament's security committee. "They are most concerned about bombs and terrorist attacks."

So now the ball is in Washington's court. If there is to be a new Russia policy, it must be driven by Bush. It will be largely up to him to decide whether America truly desires closer ties with Russia, a nation often derided as a corrupt "kleptocracy." In its new global war, the U.S. must determine how much Russia's support is worth.

By Paul Starobin in Moscow, with Catherine Belton in Moscow and Stan Crock in Washington



OPEN-AIR TAILORS IN PESHAWAR *Reforms already under way could be solidified with Western help*

PAKISTAN

A NEW CHANCE FOR PAKISTAN

Western aid could boost its moribund economy—if corruption is controlled

When Osama bin Laden recently exhorted Pakistanis to launch a holy war against America, his call resounded with a 29-year-old truck driver named Ahmed.

In recent years, Ahmed (his only name) has had an increasingly difficult time eking out a living hauling cotton to Pakistan's main port and business center, Karachi. Like many poor Pakistanis, he believes bin Laden and his cohorts have the answer to their problems. "I support holy war," Ahmed says, as he washes his 1991 Nissan truck with a rag.

As Pakistan joins America's antiterror coalition, its government faces a daunting double task: quelling such pockets of popular support for Islamic extremists and turning Pakistan into a functioning country. Much will depend on prudent

management and more aid from abroad. "Pakistan's economic problems are self-inflicted," says Finance Minister Shaukat Aziz. "The single most important contributor historically has been bad governance and corruption."

Indeed, because of decades of economic mismanagement, the current military regime of President Pervez Musharraf spends most of its budget servicing a \$37 billion foreign debt. Much of the rest goes for defense. That

leaves precious little for education, infrastructure, and social programs—desperately needed in a country where fully half the population can't read and some 42 million of its 130 million people earn well under a dollar a day. Foreign investors have long since lost faith in Pakistan, and so have many local business owners. "Growth is slow because people are not investing," says Raza Habib, an executive at the Habib group of companies, which makes everything from paper bags to Toyotas. "Because of the instability, people prefer to keep their money in their pockets."

Pakistan has been an economic basket case for so long that it's hard for citizens to imagine anything different. But now, in the wake of the terrorist attacks, its economy is poised to go

boost. When Musharraf pledged support for America's war on terrorism, Pakistan once again became a key U.S. ally—as it was in the 1980s during the war against the Soviets in neighboring Afghanistan.

Washington is already rewarding Islamabad. The U.S. has lifted sanctions imposed after Pakistan detonated nuclear bombs in 1998. And it has moved up the rescheduling of \$379 million in government-to-government debt. More is expected from other donors at a meeting of the Paris Club of government creditors later this year. The U.S. also is likely to back moves by the World Bank and International Monetary Fund to provide billions in aid and more loans. Says Aziz: "The IMF and Paris Club will give the economy a tremendous boost in terms of our external account and domestic growth."

So will stepped-up economic reforms. Since becoming Finance Minister in 1999, Aziz, a former Citibank executive, has started privatizing state-run industries, pruning public payrolls, and gradually phasing out costly energy subsidies. Thanks to these efforts, on the eve of the Sept. 11 attacks, Pakistan was credited for the first time ever with adhering to an IMF program and is slated to receive \$131 million, the fourth and final tranche of a 10-month IMF program negotiated last December.

AMPING DOWN. The government has boosted revenues. Last year, Islamabad introduced a 15% to 22% general sales tax and in 1999 clamped down on rampant income tax evasion. The result: a 20% jump in tax revenues in a year that saw the economy grow at 2.6%. Combined with spending cuts, that helped trim the fiscal deficit to 5.3% of gross domestic product in fiscal 2000 from 6.4% a year before. While some Pakistanis say Aziz should have gone further, Sakib Sherani, chief economist at ABN Amro Bank in Islamabad, says, "I'd give the government program a thumbs-up." Still, Pakistan remains a dan-

AT A GLANCE

	1990	2000
GDP GROWTH	5.6%	2.6%
POVERTY RATE	23%	30%
BUDGET DEFICIT/GDP	-5.5%	-5.9%
INFLATION	9.1%	4.4%
EXPORTS	\$5.6 B	\$8.6 B
IMPORTS	\$7.4 B	\$10.9 B
PUBLIC DEBT/GDP	79%	56.7%
FOREIGN DIRECT INVESTMENT	\$243 M	\$364 M*

*Estimate Data: *BusinessWeek*, Economist Intelligence Unit

gerous place to do business. In July, Shaukat Mirza, managing director of Pakistan State Oil (PSO), was shot to death on his way to work. Why he was gunned down remains unclear, but he had been trying to root out corruption. Says a Pakistani banker living in New York: "How are you going to invest in a country where the head of the PSO is shot in downtown Karachi?"

Indeed, overseas investors have been giving Pakistan a wide berth. Last fiscal year, foreign investment was a paltry \$425 million. And the steady devaluation of the Pakistani rupee since the early 1990s, combined with market manipulation on the Karachi Stock Exchange, has kept overseas portfolio investors away. Earlier this year, J.P. Morgan Chase & Co., one of the last foreign companies to hold a seat on the exchange, closed its brokerage operation.

So far, Western companies in Pakistan have reported no attacks since bin Laden called for a Pakistani *jihād*

against America. Caltex Oil Pakistan Ltd. Managing Director Arshad Nasar says that apart from interruptions to traffic caused by pro-Taliban demonstrations, "nothing has taken place that would affect business." Still, he has beefed up security around Caltex' distribution depot at Karachi's port, and he now varies his routes and schedule.

Pakistani businesses, and especially the crucial textiles and garment industries that account for 60% of exports, were already hurting before the terror strike. Zafar Chaudhury, general manager of Ammar Textiles, the nation's largest garment maker, was looking for new markets to offset declining orders from the likes of the Gap, Tommy Hilfiger, and Levi Strauss. The impending war has dashed those hopes.

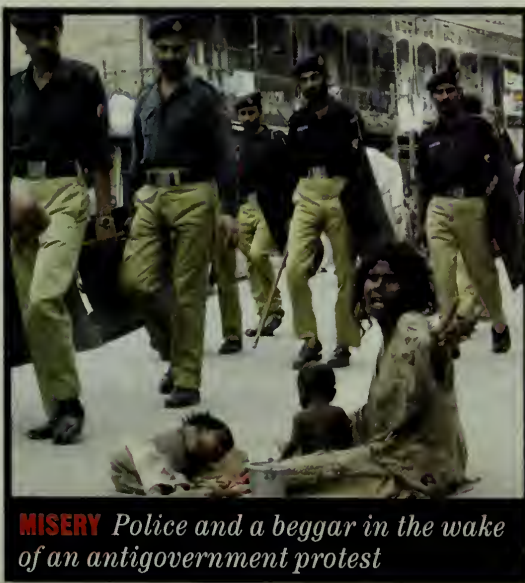
LONG TERM? What Pakistan needs, it is widely agreed, is a kind of Marshall Plan that not only would pump money into the economy but also rebuild institutions. "We should ask for something to follow through after the problem is solved that helps society come back to normalcy," says Zahid Adamjee, a scion of one of Pakistan's oldest and most prominent business families. Humayun Bashir, general manager for IBM's Pakistan operations, is skeptical about a long-term commitment from Washington. "Now, Pakistan finds itself on the right side of a lot of things," he says. "But I don't know for how long."

Other execs wonder if their own government can be trusted with a new flood of international largesse. Most Pakistanis believe billions in previous foreign loans ended up in the bank accounts of the generals and politicians. For his part, Finance Minister Aziz insists that aid and debt relief will

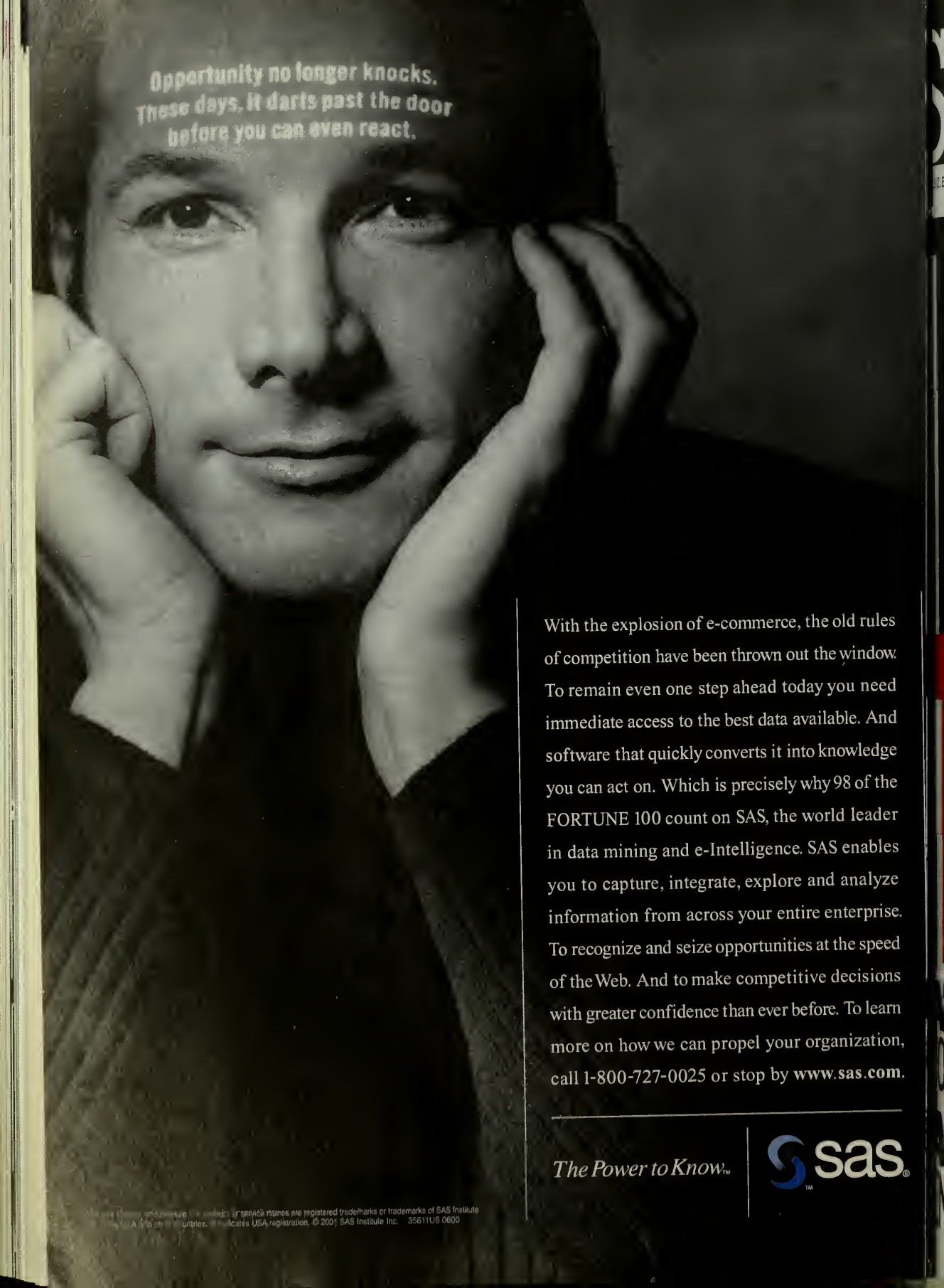
be used properly and could ease the sting of reform as the government goes about privatizing state industries, improving tax collection even more, and further reining in government spending. "If we get more [aid], our ability to reform will increase," he says.

Still, the doubters are everywhere. As a nation, says Habib, "we don't live within our means. The biggest guilty party is the army, and they're in charge." Still, the elected civilians of previous governments were no panacea either. So Pakistani businesspeople, skeptical as they are of the outcome, have no choice but to trust Musharraf and Aziz—and their new American friends.

By Frederik Balfour in Karachi and Manjeet Kripalani in Bombay



MISERY Police and a beggar in the wake of an antigovernment protest



Opportunity no longer knocks.
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BusinessWeek

Small Biz

How to Make
e-Sales Stick
Why Less Work
Helps Profits

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THE RESOURCE FOR ENTREPRENEURS

OCTOBER 8, 2001

TOUGHER TIMES

AT HOME: HOW THE OUTLOOK
FOR SMALL COMPANIES HAS DIMMED
ABROAD: WHY EXPORTS BY
ENTREPRENEURS ARE FIZZLING



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BusinessWeek Small Biz

10/8/2001

SPECIAL REPORT

Tougher Times

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Brace yourself. Even if you're not in New York or Washington, D.C., your company will feel the economic shock waves from last month's terrorist attack

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Small exporters were already plagued by the strong dollar and poor access to markets. The terror bombings will make their task even harder

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Exporters like Al Merritt are in trouble (page 14)

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How to figure the costs of a new office—and whether you need one at all

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This boss promotes work-life balance, but niceness has nothing to do with it

UNDER 30

19 Marie Van de Mark says her company gives her the stability that her troubled childhood lacked

SMALL BIZ
ONLINE

Tax Relief

The IRS has relaxed deadlines for individual and business taxpayers affected by the Sept. 11 terrorist attacks. Eligible taxpayers include those who live or work in New York City or Arlington County, Va., as well as relief workers, families of victims on the hijacked airplanes, and taxpayers whose records were maintained in New York City or Arlington County. Taxpayers asking for the relief should write in red ink atop their returns: "September 11, 2001 — Terrorist Attack." Check our Web site for the list of IRS guidelines.

Martial Plan

Businesses outside New York and Washington may be eligible for relief. The Small Business Administration has extended its disaster loan program to cover small businesses affected by the callup of military reserves. For the full stories, visit smallbiz.businessweek.com

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Health-Care Blues

DOUBLE-DIGIT JUMP IN COSTS HIT SMALL BIZ

HERE'S A HEALTH SCARE: Premiums for employer-sponsored health insurance for small companies increased an average 12.5% in 2000, the largest increase since 1992, says a survey released by the Kaiser Family Foundation in September. "This is as dramatic an increase as we've seen," says Larry Levitt, vice-president of the foundation and the study's co-author. "This is bad news for employers and worse news for workers." Indeed, 42% of small firms say that next year they will likely have their **EMPLOYEES PAY A BIGGER SHARE OF PREMIUMS**.

With costs rising and the economy slowing, the level of health coverage for small companies is expected to fall after three years of growth, says Paul Fronst of the Employee Benefit Research Institute in Washington. Already, the percentage of small companies offering any health benefits has sunk from 67% in 2000 to 65% in 2001. The worst part is, there's no cure in sight.

SO THEY SAY

"I don't even know what normal is anymore."

—MAZIN RAMADAN, CEO, 4thpass Inc., on the Sept. 11 attacks (Page 7)

ONE IOTA

NET GAIN:

Percentage of small-biz owners who say their Web site has increased profits.

Data: National Federation of Independent Business

8.4

No Breaks For the Boss

Who jumps in when things get busy? More than 83% of entrepreneurs put in extra hours themselves, says a National Federation of Independent Business poll, while just 63% of employees do. "For employees, working overtime gets old in a hurry," says survey author William J. Dennis Jr. Ownership's grand, ain't it?



Angels' Hope

MONEYMEN SEEK GOOD MANAGERS

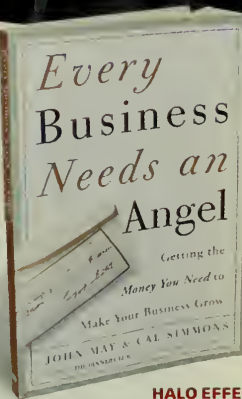
ASPIRING ENTREPRENEURS usually want lots of guidance—and plenty of cash. The lucky ones get both from “angel investors,” who funnel \$30 billion into new companies every year.

But how do you win the attention of a prominent angel? In their new book, *Every Business Needs an Angel* (Crown Business, \$27.50), Washington (D.C.) angel investors John May and Cal Simmons share insight on how angels size up entrepreneurs. Their first concern: **“WE BET ON THE MANAGERS,”** says Simmons. “A good idea with a bad leader isn’t going anywhere.”

Simmons, 50, who has founded 12 companies over the past two decades, says to make sure your pitch carefully balances hype with realistic projections. Don’t hide potential weaknesses—your investors will find out sooner or later. And, he adds, “keep your ego in check,” or you’ll lose out on the angel’s experience, input, and networks. Not much point in having angels, after all, if you don’t let them watch over you.

You’ve Come a Long Way, Baby

ENTREPRENEURSHIP IS ALL ABOUT CHANGE. So the National Commission on Entrepreneurship decided to study how entrepreneurs themselves have changed over the years. A lot, it turns out. In 1917 the median age of successful entrepreneurs was 40, vs. 26.5 in 1997. Why? They had to accumulate savings—and so, not surprisingly, they had more experience in their industry. Years ago, starting a business was for those with few other options. Today’s entrepreneurs usually have myriad opportunities, and **EXPERIENCE ISN’T A DEFINING FACTOR.** As for savings, entrepreneurs now come from wealthier backgrounds. Younger, wealthier, less hidebound—it might just add up to new and improved.



HALO EFFECT: May and Simmons warn against overhype and egomania



SOUND BITES

Joel Getzler, a New York turnaround consultant, on HOW TO PREVENT MANAGEMENT CRISES

What are the alarm bells that signal a crisis at hand?

A crisis usually means a cash crisis, which is a self-evident problem. But it's often caused by the owner's mismanagement. It's the same thing if your inventories are high and you're still buying or if you aren't make payments to vendors and you haven't negotiated new terms yet.

What kinds of management mistakes lead to crisis?

Entrepreneurs are too close to their businesses and tend to be egotistical. The same attitude that helped you build a business comes back to haunt you because you can't look at your business objectively and admit your own mistakes.

What can entrepreneurs do to prevent a crisis from taking root?

Surround yourself with two or three people you really trust—ideally other business owners. They should be people you can talk to about your business and who can ask pointed questions that you're then willing to answer honestly.



Worried Workers

EMPLOYEES AT SMALL OUTFITS SAY ON-THE-JOB STRESS CAN COME FROM MANY SOURCES

51%

of small-company employees feel stressed by their workload

29%

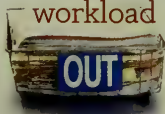
cite job security as a source of workplace angst

16%

are worried about issues of fair pay

2%

say they suffer stress from a relationship with a peer or supervisor



Data: CompPsych Corp.

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= 2 dozen hot meals

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FRONT

LINE

NEWS
ANALYSIS
IDEAS FOR ENTREPRENEURS

STATS OF THE MONTH

30%

of small-business owners raised wages for employees in August

57%

of lenders say credit to small biz will tighten in the next 6 months

50%

of small companies favor a patients' bill of rights



DISASTER STRIKES
The effects of the attack are being felt by a range of small businesses

ECONOMY

The Impact of Terror

WHEN WILL SMALL-BIZ CONFIDENCE COME BACK? **BY Larry Kanter**

FOR VIVEK WADHWA, it was supposed to be the best week of the year. Following a four-month drought, in which he failed to complete a single deal, the founder of Relativity Technologies, a Cary (N.C.) software developer, was on the

verge of closing five major sales—enough, he hoped, to send his company into the black, and a sign that the toughest period in Relativity's four-year history was drawing to a close.

Then, on the morning of Tuesday, Sept. 11,

terrorists attacked New York and Washington. As Wadhwa, 44, watched the grim events unfold on television, his 85-person company received a blow of its own: Each of the five pending deals was now on hold because the clients, most of them large corporations, were postponing all spending decisions. "Who knows how long it's going to be now?" says Wadhwa, an Indian immigrant with two decades in the U.S. "I am nervous as hell."

He's not the only one. The Sept. 11 attack, which sent the stock market plunging, has darkened the outlook of many of the nation's entrepreneurs as well. The U.S. economy was teetering

But since the attack, entrepreneurs like Mazin Ramadan, CEO of 4thpass Inc., a telecommunications software company in Seattle with 50 employees, are finding it hard to feel confident. "I don't want to think about making new sales until things go back to normal," the 33-year-old entrepreneur says. "But I don't even know what normal is anymore." Ramadan's most pressing concern right now is travel. At any given time, he has up to nine employees working in three different countries. With the airline industry in turmoil, Ramadan fears a huge spike in travel costs will prove overwhelming. As a result, he plans to replace much of

The question is whether individual cutbacks like Ramadan's and Fritz's will result in a short-term slowdown or a full-scale, small-business recession. "It's definitely going to push you into recessionary conditions," says Jack Kyser, chief economist of the Los Angeles Economic Development Corp., who says most small outfits lack the resources to weather a sustained drop in corporate and consumer spending. Roger Harris, president of Padgett Business Services, an Athens (Ga.) accounting firm with some 15,000 small-business customers, expects clients to carefully scrutinize every expense. "Every time they place an order, they're thinking about whether they really need it," he says.

Not Prone To Panic

Political and economic upheavals don't always put a crimp on small-business optimism



Data: National Federation of Independent Business

on the edge even before the terrorists struck. Now, many fear a recession could be inevitable. Says Brian Headd, an economist with the U.S. Small Business Administration's Office of Advocacy: "All bets are off."

FROM OPTIMISM TO FEAR

THAT COULD MEAN a striking reversal of fortune for entrepreneurs. In August, one-third of small-business owners reported sales increases, up from just 26% in June, according to the National Federation of Independent Business. Reports of declines fell to 26%, from 37%, over the same period. That helped send the NFIB's index of small-business optimism to a 12-month high in August—a sign that many entrepreneurs felt the economy had hit bottom.

his U.S. and international travel with videoconferencing.

Decisions like that already are sending shock waves through other small businesses. Corey Fritz, CEO of SouthCoast Rent-A-Car, a 12-person rental-car agency in Newport Beach, Calif., expected his 2001 sales to be 15% more than the \$1.2 million he brought in last year. But since Sept. 11, daily revenues have plunged more than 25%—and he sees few signs that they'll pick up anytime soon. So Fritz plans to lay off two part-time workers and cut the hours of his full-timers. Plus, he's frantically revising his business plan, hoping that by targeting local companies, he can reduce his reliance on business travelers. "Businesses don't want to fly their employees anywhere right now," Fritz says.

SHOWING SPIRIT

OTHERS AREN'T so discouraged. The attack "is not so much a big economic event as it is a big political event," says William C. Dunkelberg, chief economist of the NFIB. His research suggests that small-business owners tend to remain chronically optimistic following political and economic upheaval (chart). Dunkelberg's prediction for the current crisis: "We'll be in shock for awhile. The stock market will flounder. But it won't last long."

Indeed, it's not hard to find a optimistic small-business owner. John Sheaffer, president of Sysix Technologies LLC, a 50-person hardware and infrastructure provider in Westmont, Ill., is having his best year ever in 2000 with sales of about \$35 million. He has no plans to slow down now. His sales people were working as hard as ever, and clients, he says, are responding. "There is a wave of patriotism," says Sheaffer, 36. "Everyone wants to show their spirit by getting back to doing what they do every day." But flag-waving alone won't pay the bills. Customers have to resume waving money around again—and right now, business-as-usual seems too much to expect.

—with Naween A. Mangi in New York

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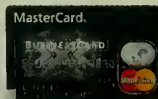
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TRENDS

The e-Perks Arrive

BUT SMALL COMPANIES RESIST ONLINE BANKING

TO ATTRACT small-business customers, community banks are unveiling an array of new online services: direct deposit for payroll, detailed balance reporting, wire transfers. Over the next three years, 74% of community banks plan to offer such products, compared with just 27% today, says Grant Thornton International.

Just one problem: Small-biz owners have little appetite for Internet banking. In the second quarter, just 15% of small businesses used their primary bank's Web site for transactions—and that's down from 19% in the first quarter, says Barlow Research Associates Inc.

Why the reluctance? Entrepreneurs still tend to choose their banks based on old-fashioned customer service, not

technology. "I can call my banker at home on a Saturday," says Eddie Herbert, president of You Oughta Be In Pictures Inc., a three-person photo studio in Maurice, La. who's not inclined to use cyberbanking. "If I apply for a loan, I want to hear why I didn't get it."

Still, some banks have proven they can make it work. At American Business Bank in Los Angeles, 20% of clients use the Web to monitor transactions, transfer funds, stop payments on checks, and pay bills. But that's because customers still get plenty of personal attention, says founder Donald P. Johnson.

Take Roxanne Medina, chief financial officer at Howard Building Corp., a 75-person construction com-

Cyber Skeptics

Percentage of small companies that made transactions at bank Web sites



pany in Glendale, Calif. Medina logged onto American Business Bank's home page to transfer money and monitor interest rates on the company's accounts. For trickier transactions, she says: "I can pick up the phone and they will hand-carry you through the system." That's what you expect from a community bank. If the bankers won't provide it, they'll end up with a bunch of costly toys and no one to play with.

—NAWEEN A. MANCINI

AT A GLANCE

The Facts:

Community banks are targeting small biz with online banking

The Problem: Most entrepreneurs resist Web banking

The Future: It'll work only if banks also offer personalized service



Q I'd like to rent space to expand my home-based engineering consultancy, but I'm worried about cash flow.

—T. M., Randburg, South Africa

A Try this experiment: Charge yourself rent for six months. Put the money in the bank and

don't touch it. You'll see clearly how the added expense affects cash flow. If you think you can handle it, have your accountant prepare a cash-flow analysis to determine how much new business you'll need to make it worth your while. Then, consider a sublet or share to keep down up-front costs, or

think about an office suite, which typically provides secretarial support, furniture, and Web connections. Finally, be sure you really need an office. With virtual-office software and teleconferencing, clients don't have to know how small your firm really is. —KAREN E. KLI

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SATISFIED
Sincerely Yours' Parker got help from Newgistics

DIGITAL MANAGER

Happy Returns

HOW TO DEAL WITH REJECTED WEB PURCHASES

Some
"reverse
logistics"
outfits
handle
everything

SELLING OVER THE WEB is tough enough, and then comes the hard part: getting shoppers to keep the merchandise they have bought. The fact is, an unusually high number of e-shoppers return their purchases. Why? Sometimes, products don't look like their nonvirtual selves on a Web page, so online shoppers hedge their bets by deliberately overbuying. Sometimes, orders don't arrive in time, especially around the holidays. The result: Returns

Web sales run as high as 40%—compared to an average 8% for cata-

logs and even less for traditional stores.

Returns are a pain for any retailer. They suck up employee time and warehouse space and generate no profits. While this avalanche of rejected merchandise from Web sales can strain a big company with an internal logistics unit, it can bury a small one. That's why Janice Parker, president of Sincerely Yours, a Lewisville (Tex.) home-decor business, gave up handling the returns herself. After less than a year online, Parker turned the job over to Newgistics Inc., an Austin (Tex.) company that specializes in "reverse logistics."

Now, from the moment a Sincerely Yours customer decides to send back an item of merchandise, Newgistics takes over the matter, leaving Parker's 22-person staff to focus on outbound sales and shipments. "The customer is

RANDOM ACCESS



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If you access the Net by phone, check out modems that conform to the new V.92 standard. You'll connect 25% faster than with a 56K and improve data flow by up to 50%—plus they work with call waiting. Manufacturers include Actiontec Electronics (www.actiontec.com); U.S. Robotics (www.usr.com); and Diamond Multimedia (www.diamondmm.com).



PLAYING CATCHUP

Need help monitoring updates for software applications and drivers—those little programs that control computer accessories? The Web-based CatchUp program scans for outdated software and offers links to sites where you can download the latest versions. (www.catchup.com).



MORE TO SCAN

ScanSoft's OmniPage Pro 11 optical character recognition program lets you scan Adobe Acrobat (PDF) files and turn them into editable text. Until now, OCR programs didn't work with PDF files. (www.scansoft.com).

happy. We're happy," says Parker, who reports about 8% of her sales come back. "It's a great solution."

In fact, it's a solution that is already being used by so many small businesses that software companies and consultants are flocking into the reverse logistics business. Basically, these companies operate in one of three ways. Full-service outfits such as Newgistics handle every aspect of the process, typically for \$1 to \$1.50 per return. If you don't want to outsource the whole thing, niche firms can take over pieces of it, such as transportation or liquidation. Or you can do what big comp-

ies do: Get someone to help you design and manage a returns program in-house. All three have merit.

CATALOG MISTAKES

THE FULL-SERVICE OPTION is gaining, even among companies that once tried to handle returns in-house. Take Ziba.com, a North Adams (Mass.) vendor of decor and gift items that signed up with ClientLogic in Nashville. Every package eZiba.com ships includes return labels addressed to a ClientLogic warehouse in Delaware. When a return arrives, ClientLogic decides whether the item is suitable for resale or should be liquidated. It also looks for patterns headquarters should know about. Earlier this year, a certain vase kept showing up. It turned out that the artwork on the Web site depicted its size and color incorrectly, so disappointed consumers sent them back. eZiba made the fix.

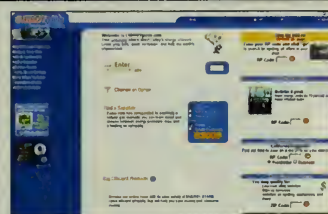
For all their convenience, a full-service company may not be your best choice. Before signing up, audit your returns process carefully. If you're small, you may need help only in certain areas, says Kevin Noonan, an analyst at Yan-

kee Group. ReturnBuy Inc. in Ashburn, Va., focuses on finding profitable ways to dispose of merchandise that can't be resold by the original vendor. The company prides itself on using online auctions. CEO Lawrence Snapp calls it "intelligent merchandising"—studying the habits of auction site shoppers and putting that knowledge to work. "Anyone can sell something on eBay. But it's our core competency," says Snapp. "We look at over 50 variables to determine how and when to do it." Digital cameras, for instance, sell best at the lunch hour, when affluent shoppers use high-speed connections in the office.

SHOULD YOU OUTSOURCE?

SOME COMPANIES, such as Red Envelope Inc., a San Francisco-based online retailer of specialty gifts wouldn't think of not doing the job themselves. Its returns often come from gift recipients rather than buyers. "We wouldn't want to risk that contact with a potential new customer to a third party," says CEO Martin McClanan. So Red Envelope, with 80 full-time employees and about \$30 million in revenues, staffs a

JUST BROWSING



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WEB ADDRESS:

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WHAT'S NOT: It takes a while, and you have to supply obscure data, like your facility's insulation rating and how much of your wall is glass

Return to Sender

A host of new companies will handle your online returns for a negotiated price. A sampling:

NAME

Newgistics Inc

www.newgistics.com

returnbuy

www.returnbuy.com

UPS e-logistics

www.upslogistics.com

The Return Exchange

www.thereturnexchange.com

return.com

www.return.com

SERVICES

Provides full service on returns, including return shipping and liquidation. Also offers selected services, such as return labels.

Part owned by eBay, Returnbuy's expertise is merchandise liquidation via online auction. Fees are a portion of the auction take.

The package and shipping company offers a host of services for e-commerce companies including transportation and tracking of returned merchandise.

Specializes in merchandise liquidation.

A partnership between Innotrak Corp. and Mail Boxes Etc. Provides returns management as well as customer-service programs, such as call centers and live chat.

central warehouse in Wilmington, Ohio, with 20 to 30 people. McClanan concedes it's expensive, but he only wants people committed to the "Red Envelope way" dealing with these potential customers. Outsiders, he thinks, shouldn't be offering discounts or making other special arrangements.

How do you know if you need help with returns? Experts say it doesn't turn on the size of your company but rather the volume of your shipping. A company doing 50 orders a week shouldn't bother paying someone else for help with logistics, reverse or otherwise. If you're up to more than 1,000 orders a week, outsourcing offers potential rewards, says Darren Bien, an analyst for Jupiter Media Metrix, an Internet consulting firm in New York. Whatever you choose to do, handling returns efficiently doesn't just make your customers happy, he says. It can cut your losses on what's inevitably a fact of e-tailing life. "It's a way to improve your profitability," says Bien. That's something few e-commerce companies will want to send back.—ELLEN NEUBORNE

@SB Should you let someone else handle returns? For help deciding, click Online Extras at smallbiz.businessweek.com

FALLOUT:

Al Merritt's medical-equipment business was already hurt by the slowdown. The terrorist attacks will only make things worse, he says



THE EXPORT BUST

A ONCE-PROMISING NICHE IS SHRINKING
BY NAWEEN A. MANGI

FOR NEARLY 15 YEARS, THE GLOBAL MARKETPLACE was good to Al Merritt. Since launching MD International Inc., a Miami exporter of medical equipment, in 1987, Merritt's revenues have grown by at least 25% a year. His once-tiny startup is now a \$60 million company with 85 employees, many of whom work in a shiny, \$5 million headquarters. Customers from Latin America and the Caribbean come to train on the new equipment in the company's state-of-the-art operating room.

But these days, and for the first time in his career doing business abroad, Merritt is learning that the global economy isn't always such a friendly place.

Over the past 12 months, Merritt's sales have fallen 17%—the result of a persistently strong U. S. dollar and a host of tough new rivals in Europe. Deals that would once have been easy are unraveling, including a \$400,000 contract for surgical tables from a Brazilian hospital and a \$200,000 order for diagnostic equipment from the Mexican government, both of

which went to a supplier in Germany. In all, Merritt, 42, figures he has lost \$15 million in new business in the last 18 months, which has forced him to dismiss a dozen workers and close a division. "This is the worst I've ever seen," he told *Small Biz* in August.

That was before Sept. 11, when business across the globe ground to a halt after the attacks on New York and Washington. Merritt's employees were stranded as far away as Peru. He figures he lost \$220,000 in sales on the first day, when executives at a trade show were too distraught to conduct business. A long-anticipated sales trip to Europe had to be canceled, and several hundred thousand dollars worth of cargo remained locked in warehouses. "We were already in a weakened situation," says Merritt. "This will require us to tighten up even more."

It's a far cry from the gilded days of global trade in the 1990s, when thousands of small-business owners struck gold by targeting growing demand in foreign markets (chart). Indeed, the world has seldom seemed less hospitable to U.S. exporters. The strong dollar—up 30% against the euro since January, 1999—has meant that U.S. goods and services are priced out of many foreign markets, and a global economic slowdown has eroded demand even further. Meanwhile, competition is tougher than ever, especially from the European Union, which has inked 25 free-trade deals with countries all over the world, particularly in Latin America, a key market for U.S.-based exporters. The U.S., by contrast, has signed only two of the world's 134 free-trade agreements.

Then came last month's terror attacks. For a week, it was nearly impossible for traders to send or receive goods. Even with traffic flowing again, the fallout from the attacks provides a chilling reminder of just how risky venturing abroad can be. "Globalization has just seen a major interruption," says Robert Duncan, president of Leawood Export Finance Inc., a capital-goods exporter in Overland Park, Kan., who has been doing business overseas since 1995. "The impact will be huge."

Much of that impact may be felt by entrepreneurs. Small business now makes up 88% of America's exporters, and accounts for a fifth of the value of U.S. exports, according to the Commerce Dept. Business was already suffering this year, with

the dollar value of all U.S. exports falling to \$83.7 billion in July—the lowest monthly level since January, 2000.

That drop is causing untold headaches for small-business execs such as Duncan, whose 18-person operation sells and finances deals for construction machinery and manufacturing equipment. Exports to Mexico now account for 75% of Duncan's \$7.5 million in sales. For much of the 1990s, that was a good thing. But the Mexican economy has contracted for three quarters in a row, sending Duncan's sales down nearly 30%. The company looked elsewhere, but the strong dollar has priced it out of the African market and demand in Asia is weak. To cope, Duncan, 58, has dismissed eight employees. Now he fears the Sept. 11 attack will only make things tougher. "Markets abroad are going to be very, very cautious," he says.

ALMIGHTY DOLLAR

AS A RESULT, ALL EYES ARE ON the global financial markets. If the appetite for U.S. investments declines as a result of the terrorist attacks, the dollar could weaken. This could give small exporters a tiny break, making their goods more affordable at a time when demand is falling. But that's far from a sure thing. Meanwhile, the combination of a strong dollar and weak sales puts tremendous pressure on margins for small exporters, who often can't hedge currencies like big corporations. "The dollar's been high for some time," says James Morrison, president of the Small Business Exporters Assn., a Washington trade group. "If it remains expensive now, small exporters will definitely be hurt."

To be sure, some exporters are still managing to thrive. Ann King, president of Heartland Packaging Inc., a 14-person plastic-packaging manufacturer in Pincleville, Ill., stumbled into international commerce last year, when she filled an order of gel packs for a Canadian customer. She's since been referred to three more Canadian clients, who now account for about 20% of her \$700,000 in sales. The strong dollar has made things tough, but she's coped by keeping costs under tight control and pricing her product slightly below the competition. While the terrorist attacks have forced King to cancel bus-

Export Experts

In a confusing world, here's where would-be world traders can head for a little help

International Trade Administration, U.S. Dept. of Commerce

(www.ita.doc.gov)
Provides exporting tips and solutions to common trade problems. Hosts a database of country guides and lists of potential foreign partners.

U.S. Export-Import Bank

(www.exim.gov)
Allows small companies to apply online for export financing. Sponsors export training seminars nationwide.

U.S. Chamber of Commerce

(www.uschamber.com)
Provides directory of international chambers of commerce and links to their Web pages.

U.S. Trade & Development Agency

(www.tda.gov)
Provides business leads in developing countries. Offers training grants and workshops.

Export Hotline

(www.exporthotline.com)
Provides market research on 140 countries

and several industries, free of charge.

The Federation of International Trade Associations

(www.fita.org)
Operates database of global trade shows. Provides links to sites for trade leads.

Office of International Trade, U.S. Small Business Administration

(www.sbaonline.sba.gov/OIT)
Provides comprehensive guide to exporting and tips on applying for export financing.

ness trips to Canada and Europe, where she hopes to find new customers, she's continuing to negotiate with companies in Russia and Mexico and still expects about a third of her sales to come from exports within the next three years. "I have a huge amount of pride that we've expanded this far. It's not exactly common in this rural town of 3,500 people," says King, 45. "I am not going to stop now."

That kind of persistence is crucial if small businesses are to succeed abroad—whether or not the world is in a recession, says Laurel J. Delaney, president of Global TradeSource Ltd., an international-trade consulting firm in Chicago. The most common reason entrepreneurs fail in their global adventures, she says, is lack of patience. "They encounter a couple of obstacles along the way, and they stop dead in the water," says Delaney.

Charles E. Tharp, president of Environmental Dynamics Inc., knows firsthand the importance of sticking it out. Tharp, 62, founded the Columbia (Mo.) distributor of waste-water treatment plants in 1975. He has been steadily building his offshore clientele ever since, aggressively courting overseas distributors and attending four major international trade shows a year. Today, the 60-person company makes 40% of its \$11 million in revenues from exports to 40 countries. Despite the difficulties exporters are facing, Tharp has tripled his overseas business over the past three years. Exporting, Tharp says, "is a long-term investment, and we played it that way."

GLOBAL JITTERS

THARP WAS SMART TO DIVERSIFY. Small exporters, Delaney says, should aim to get about a third of their revenues from a diversified export base. More than that, and entrepreneurs could find themselves overexposed to any number of global risks, such as currency fluctuations or political instability. In the meantime, small-business exporters need to constantly hunt for new markets and look for sales at home, too.

Of course, in an unstable political situation, finding new markets is likely to get even tougher. Some small companies may have little choice but to stay home. Securing export financing has long been a major problem for entrepreneurs, even in good times, as risk-averse banks generally avoid such deals. The terrorist attacks could foster even more caution. "The small exporter now wonders how he's going to get anything out of the country in these circumstances," says John Robson, chairman of the Export-Import Bank of the United States, which provides working capital to small exporters through a network



I WON'T STOP NOW
Against all odds, Ann King's plastic packaging business is thriving, and she vows to find new clients in Russia and Mexico

Border Crossing

The number of small exporters more than doubled during the 1990s.



Data: U.S. Dept. of Commerce

of 120 participating banks. (The EX-IM bank, which authorized \$517 million worth of working-capital finance to small exporters last year, guarantees 90% of the loan. They also sell export credit insurance—at the cost of 65¢ to \$1.13 per \$100 of shipment—to cover the risk of nonpayment by foreign buyers.)

It doesn't help that the U.S. trails Europe in efforts to set up free-trade pacts. But then, fretting about trade politics is a luxury few small

traders can afford right now. Even Al Merritt, who has long lobbied for the U.S. to move more quickly on free-trade issues, has too much on his plate. His next few weeks will be spent reassuring frazzled employees and clients, negotiating new product lines with manufacturers, and charting the next steps for his company. That's tough enough to accomplish in normal times. It's a small miracle in an age when violence has become one of the world's leading exports.



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LIFE & COMPANY

The Other Balance Sheet

HOW ONE FIRM GETS MORE PROFIT FROM LESS WORK **BY ROBIN SCHATZ**

MARGARET JOHNSON ISN'T JUST TRYING to be a nice boss. It's true the CEO of Johnson Group, a financial consulting firm in Chicago, discourages her consultants from working more than 45 hours a week in an industry where 70-hour weeks are typical. It's also hard to top the two-week, paid sabbaticals she offers all employees every three years—with a thousand bucks for expenses—in addition to generous vacations. And

it seems awfully considerate of Johnson to urge her 58 employees to build their work schedule around their lifestyles.

But, as I said, this isn't about altruism. "I'm in this to make money," she says. Quite simply, Johnson thinks that consultants who lead balanced lives produce more creative solutions for her clients—and that's good for business. "We believe that every client has the right to breakthrough thinking on every job," she tells me. "One of the ways to get there is to have something that pulls you away on a regular basis, so your subconscious will have these breakthrough thoughts."

O. K., I'm thinking, this is all a bit too New Agey for a no-nonsense exec in a navy blue

pantsuit. But her philosophy comes right out of her experience in Corporate America. As an executive in the 1980s at Beatrice Foods and Kraft Foods Inc., she often hired outside consultants. Too often, she found them overworked and unimaginative. When Johnson founded her own consulting firm 10 years ago at the age of 29, she started out by hiring MBA moms, an arrangement that met their needs for flexibility and her desire to deliver high-impact ideas to clients.

These days, the consulting staff is just 51% female. Rita S. Gallagher, 43, a mother of two with an MBA from the University of Chicago, logs in a 35-hour week but manages to lead a Girl Scout troop on Tuesday afternoons. For Michael Jefvert, 42, flexibility means that he bowls most Thursday nights and works out at the gym in the mornings.



JOHNSON: Flexible schedules get results for clients and the company

"When you're away from the client," he says, "that doesn't mean you're not thinking about your day and problem. Your brain is still spinning."

Of course, all the flexibility in the world won't turn a dull thinker into the consulting equivalent of Mozart or Picasso. You have to hire creative people to start with—and then reward them for their innovations. Among his incentive plans, Johnson offers a "above and beyond award" for exceeding the client's expectations. Like the consultant who suggested that his client, an automotive company, start charging their customers for shipping and handling as a new revenue

stream—something unheard of in the industry at the time. The client was thrilled. "The consultant wasn't asked to do it," says Johnson. "It just came to her one day."

That sort of spontaneous combustion pleases clients like Faye L. Katt, vice-president for employee services at health-care giant Baxter International Inc., who firmly believes Johnson Group's consultants are "very creative because of their balanced, flexible work lives."

That may be true, but consultants do pay a hefty price. They earn only about half as much as their big-firm counterparts. Still, turnover runs just about 8% annually, vs. an industry average of 25%. "Money is not everything," says consultant Jefvert, who worked 13 years at Amoco. "It's a trade-off, but one that I'm very comfortable with."

As for Johnson, she's very comfortable with her financial results, thank you. Last year's revenues of \$5 million are on track to double this year. Profits, she says, should be up 250%, and she's planning at least one new office, maybe two, for next year. (She won't say where.) All in all, I'd say being nice has paid off for Johnson, that's the bottom line.

@SB Schatz, an editor at Small Biz, can be reached at robin_schatz@businessweek.com

SCHATZ



Bottom line: It really pays to be nice



AT A GLANCE

WHO: Marie Van de Mark, 27**COMPANY:** Jam Enterprise**WHERE:** North Hollywood, Calif.**REVENUES:** \$2 million**EMPLOYEES:** 10**THE PRODUCT:** Promotional items made from metal**QUOTE:** "I didn't grow up in a bedroom full of computers. We played with sticks and twigs. And what makes my products special is that they're created by hand."

Garage Tale

What drove Marie Van de Mark, 27, to become an entrepreneur? A rough childhood: She spent four years in a New York State group home before settling in securely at 16 with a foster family, and always felt owning a business would provide the stability she had lacked. Why promotional products? Simply because a friend introduced her to the trade when she moved to Los Angeles six years ago. At first she assembled keychains in her garage for a small marketing company. Before long, Van de Mark began experimenting with design, shunning most new technology in favor of a handmade look, and by last year she'd saved enough to equip a factory. Today, her products include book-shaped pushpins for Amazon.com Inc. and pewter sunglass cases for A/X Armani Exchange. What's next? Handcrafted gift and stationery products. Certainly she has something to write home about. —NAWEEN A. MANGI

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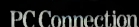
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NATIONAL DEFENSE

THE SILICON BRIGADE SIGNS UP

Techies offer Washington scads of security gizmos

In 1999, Anthony Sdao launched a startup aimed at catching underage kids trying to buy beer or cigarettes. The idea was to sell

identification scanners that could verify whether a driver's license was valid. But that was before the infamy of Sept. 11, 2001.

Now Sdao, CEO of Logix Corp. in Longmont, Colo., is joining the crush of high-tech companies eager to help Washington fight terrorism. For Logix, that has meant rejiggering its handheld scanner so it can do more than authenticate passports and other IDs. It also displays the cardholder's physical characteristics—hair color, height, etc.—so officials can make instant comparisons. “We’ve never even thought of offering this before,” says Sdao, who has received inquiries from airports and agencies including the Secret Service. “But when the disaster happened, we thought about what we could do here.”

DIGITAL TRAILS. Like Sdao, executives across the U.S. are looking back in horror at the cascade of security and intelligence snafus that preceded the Sept. 11 attacks and rallying to give Washington a hand. This newfound fervor is likely to field a whole host of techie tools that will be crucial in helping uncover and analyze the digital trails that are at the heart of the fight against terrorism.

“We’re making sure we have engineering teams responding to all calls,” says Oracle Corp. CEO Lawrence J. Ellison, who is pressing for a face-to-face with newly appointed Office of Homeland Security czar Governor Tom Ridge.

Take data mining. IBM, Computer Associates International Inc., and a pla-

compiles five separately maintained lists of barred organizations and individuals and sells them to business to prevent U.S. exports from getting into the wrong hands. ClearCross is offering its services free to the Bureau of Export Administration and U.S. Customs, which are constrained by a lack of resources. “Customs only looks at 2% to 4% of goods coming into the country and probably less than 1% of goods being exported,” says ClearCross’ Peter Baish, a former Customs official.

Data mining can also improve government intelligence. One industry source says the FBI will soon license an application originally developed for sales and manufacturing forecasting. Among other things, the software will flag abnormal behavior, such as purchases of blocks of one-way airline tickets.

The push to tighten borders has landed biometrics in the spotlight. This digital technology positively identifies people by scanning features such as the irises of eyes. Biometric systems match these features, which are unique to each individual, against law-enforcement and other databases. The Federal Aviation Administration is considering trials at U.S. airports of facial-recognition technology, which is already in use in Europe.

At the same time, the Defense Advanced Research Projects Agency is working with biometrics systems maker Visionics Corp. on a

Human-ID-at-a-Distance project. The concept is to identify people at up to 500 feet and determine whether or not they are carrying weapons. Similar but shorter range systems already exist. This technology could be deployed around embassies and other sensitive locations.

The good news is that many of these technologies need only to be tinkered with to address weaknesses in U.S. systems. The bad news, of course, is that it took a catastrophe to realize it.

By Linda Himmelstein in San Mateo, with Jim Kerstetter in San Mateo and Heather Green in New York



IN THE SPOTLIGHT Biometrics identifies people by scanning features such as irises or fingerprints

toon of newcomers have systems for extracting valuable information from raw commercial or scientific data. At the moment, few agencies share information effectively. “Ask what terrorists are active in the U.S., or who called a specific terrorist from another country,” says Mark Hurd, president of Teradata Corp., a data-warehousing company that works with the government. The data probably exists, he says, “but the difficulty is in pulling [it] together.”

Software maker ClearCross Inc. of Reston, Va., collects and integrates import and export data. The company

HOW HIGH TECH CAN BOLSTER NATIONAL SECURITY

DATA MINING

Software will let government agencies share and analyze data on everything from airline passenger manifests to terrorists’ e-mail exchanges

IDENTIFICATION TOOLS

Fingerprint readers, iris scanners, and magnetic or chip-based ID cards could authenticate identities at airports and military bases

COMMUNICATIONS

Mobile phones and GPS systems are being retooled for locating 911 callers—and can also aid in tracking terrorist activities

DON'T CRY like a MAN!

JEAN HOLLANDS
**SAME
GAME**
Different
RULES
HOW TO GET AHEAD WITHOUT
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OR "MS. UNDERSTOOD"

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THE MILITARY

FROM SMART TO BRILLIANT WEAPONS

Technology could be a key factor in the new war

Only weeks before the horror of Sept. 11, an obscure Defense Dept. agency and a bevy of contractors struck a potential blow against terrorists. For the first time, they demonstrated that remotely guided weapons could target and hit moving vehicles. Even though the technology was aimed at more conventional foes, it could be just the ticket for taking out terrorists fleeing across the desert. The trick: using airborne radars and computer wizardry to steer a missile or guided bomb directly into an elusive target.

This is just one example of the leap in weapons technology since the Gulf War 10 years ago. Despite the compelling images of "smart" bombs smashing into their targets, Operation Desert Storm laid bare serious shortcomings. "We never successfully hit a single Iraqi mobile Scud launcher," says Robert Haffa, head of Northrop Grumman Inc.'s analysis center.

Because of such disappointments, the Pentagon poured millions into developing brainier systems that are now ready—or soon to be ready—for battle. These range from unmanned planes bristling with radar and other sensors for mapping rugged terrain or spotting hidden enemies to cruise missiles that can loiter overhead for hours, waiting for the best moment to strike. "In the Gulf War, we had smart weapons. Now, increasingly, we are fielding brilliant weapons," says Robert Martinage, senior defense analyst at the Center for Strategic & Budgetary Assessments.

Admittedly, new technology rarely

performs as billed. But even accounting for inevitable glitches, defense analysts believe the new smarts give the military a far greater edge. In Desert Storm and the 1999 Kosovo conflict, bad weather made air strikes impossible because the lasers used in laser-guided bombs couldn't pierce cloud cover. Now missiles and bombs get their direction from global positioning satellite systems (GPS), enabling them to reach the targets at any time. "This is going to be a 7-by-24 war," predicts John



SCIENCE REALITY A soldier displays some of high-tech equipment that's already available

Pike, director of GlobalSecurity.org. **BRAINS.** Some bombs are also equipped with sensors that can distinguish between, say, a bus or a truck, along with the brains needed to pick the right target. They could be dropped by thousands to do what once was an oxymoron—precision carpet bombing. Also, improved ground-penetrating bombs can not only pierce deep, multistoried bunkers, but also explode at precise the right level.

Meanwhile, information technology is shortening the time needed to launch attacks. During the Kosovo conflict, satellite images and data from radar-equipped 707s—part of the Joint St

veillance & Target Attack Radar System, or JSTARS—flowed in separate streams. The data had to be integrated and evaluated before any decisions could be made. But information from disparate sensors and surveillance systems is increasingly being combined electronically. Used to take days to react to new information, says Gregory F. Treverton, senior policy analyst at Rand Corp. That's shortened to hours, to minutes, and now, probably, to seconds," he says.

Of course, the most brilliant weapons are useless "if you don't know where Osama bin Laden is," cautions Robert Faltzgraff, an international security studies professor at Tufts University.

Still, new technology is bringing changes there, too. For instance, defense experts expect at Northrop Grumman's sensor-bearing

load the exact images they're seeing to command centers. "Because of these devices, you don't have to get belly to belly to get confirmation of a target," says one industry source. As a result, "whatever operation we take will clearly be at night, because our folks have capabilities no one else does."

CHALLENGES. Will all this be enough? Defense experts admit shutting down camps in countries like Afghanistan is a difficult task. "Bin Laden knows we can put holes in the ground, but disrupting his operations is more challenging," says Francis M. Cevasco, vice-president of national security consultant Hicks

THE GLOBAL HAWK CAN SCOUT TERRAIN WITHOUT HUMAN RISK

& Associates Inc. Human smarts can often trump the silicon kind.

"You can beat high tech by going very low tech," warns Neil C. Livingstone, CEO of risk management consultants Global Options Inc.

What's more, industry experts lament, the technology for gathering, integrating, and analyzing information—crucial in fighting fast-moving, shadowy foes—has gotten short shrift from the Pentagon, so it hasn't progressed as much as they would have liked. And the military's tortuous acquisition rules, plus the relatively small defense market, have kept Silicon Valley companies from playing a major role.

All that may now start to change. Clever research projects, such

as the development of computer-imaging systems that can identify people at a distance, are bound to get a major boost, predicts one industry veteran. "Wartime is a great time for innovation," he says. Analysts readily admit a high-tech military can't win what is expected to be a long-running war on terrorism all by itself. Diplomacy and choking off financial support for rogue groups is also crucial. But today's smarter, more powerful U.S. forces stand more than a fighting chance of winning battles.

By John Carey and Catherine Yang in Washington, with Otis Port in New York and Christopher Palmeri in Los Angeles

STRIKING AT TERROR

Technology is boosting the Pentagon's power to spot and attack an elusive enemy. Some key areas:

COVERT SURVEILLANCE

Sophisticated radar-equipped planes, satellites, and unmanned aerial vehicles like Global Hawk can map terrain, find and follow moving targets, and listen in on communications

SMART WEAPONS

Guided by GPS signals, cruise missiles and "smart" bombs like JDAM can find targets in any weather, tell a tank from a tractor—and hit the right one

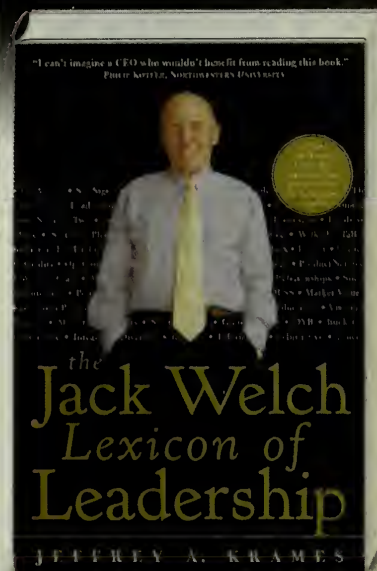
SHARP-EYED GROUND TROOPS

Better night-vision systems let commandos confirm terrorist camps without venturing too close, while satellite gear uploads what each team member sees to a command center

Global Hawk unmanned plane will also be equipped to pick up communications from terrorist camps.

Then, once potential areas of terrorist activity are located, ground troops are expected to be sent in to confirm the targets. The soldiers will be equipped not only with GPS receivers and satellite equipment that pinpoint the locations of every member of the unit, they will also carry third-generation night vision gear capable of seeing 500 yards through the gloom. A laser viewing system from Intevac, Inc., now being demonstrated, is even better. It can identify buildings, cars, and people from miles away. And the soldiers can up-

G is for GENIUS



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AIRLINES

A BAILOUT—WITH STRINGS ATTACHED

Uncle Sam may have more say in operations

Less than two weeks after terrorists hijacked and crashed four commercial jets on Sept. 11, Congress opened up the Treasury to the airline industry. Lawmakers coughed up \$5 billion in emergency aid and agreed to guarantee up to \$10 billion in borrowings. The government had shut down the airlines for nearly three days, so it's only fair that it provide compensation, the thinking in Washington went. The bailout was aimed at making the airlines whole—in effect, turning back the clock to Sept. 10.

But for airlines, Sept. 10 wasn't such a great time, either. The emergency legislation didn't touch some fundamental problems. Airlines are a cyclical business, not unlike commodity manufacturing or commercial real estate, swinging from boom to bust. Like many old-line industries, airlines have huge fixed costs; a single airliner can cost as much as a factory, so debt levels are high. And their workforces are highly unionized and highly paid. Pilots and mechanics, especially, hold enormous clout over management because their specialized skills are tough to replace.

"BANKRUPTCIES." Even so, how did such a relatively brief shutdown threaten to ground the entire industry? Even before the terrorists attacked, analysts expected the airlines to lose \$2 billion this year. Now, with fearful tourists and business travelers avoiding flights, that

could turn into a \$5 billion loss. "Even if the aid package could get them back to the status quo, the status quo is not a good place to be," says Morgan Stanley Dean Witter analyst Kevin C. Murphy. "Some carriers are mortally wounded."

Free-market advocates in Congress insisted that any airline vulnerable to bankruptcy on Sept. 10 will still face that possibility when the \$15 billion runs out. "We believe in markets, not Marxism. We have taken corrective action at the top, and we would expect that the falling of the dominoes has slowed," says Senator Charles E. Grassley (R-Iowa). But if traffic doesn't pick up enough and a bunch of airlines file for bankruptcy in the months ahead, some of those same congressmen might have to decide whether to step in again, and the precedent could be hard to ignore.

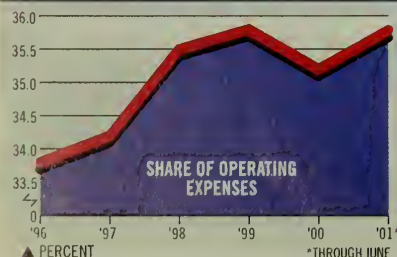
Even if Congress remains hands-off, regulators will likely face the thorny issue of how to manage an inevitable consolidation. Just months after antitrust officials blocked United Airlines Parent UAL Corp. from buying US Airways Group Inc. for fear that it would crimp



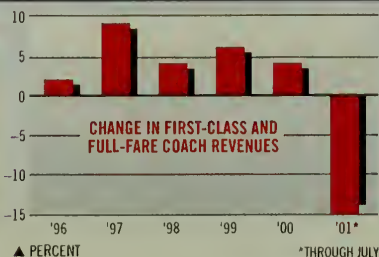
competition, they may have no choice but to act as referees as surviving airlines snap up routes and airport gates from dying carriers. Already, industry analysts are predicting a shift in politics to let even blockbuster deals through.

The bailout comes with strings that give the government more say in business decisions. For one, airline executives who earned at least \$300,000 last year can't be paid more this year next. And their severance pay can't be more than two years' salary. That's likely to draw cheers from union workers but a second condition has larger implications: In return for guaranteeing an airline's debts, the government will get warrants, stock, or stock options in airlines; the details aren't worked out yet. "There will be greater government involvement and influence," says Standard & Poor's Corp. analyst Philip B. galey. "Money doesn't come with strings."

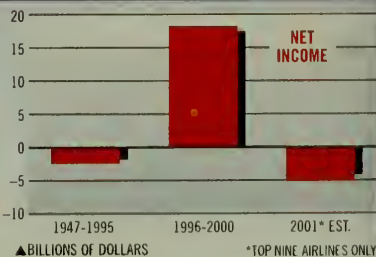
WITH AIRLINE LABOR COSTS RISING...



...AND BUSINESS TRAVEL DRYING UP...



...CARRIERS ARE LOSING MONEY AGAIN



Data: Air Transport Assn., UBS Warburg

ON THE ROPES
*Airline chiefs
 appear before
 Congress in
 February.
 Even with the
 aid package,
 analysts say
 there will be
 bankruptcies*

The weakest players aren't likely to emerge post-bailout. Topping the critical list are US Airways and America West Airlines Inc. US Airways, the nation's 10.6 carrier, has long been in trouble because of its high operating costs and small reach, which was why it solicited a takeover offer from UAL last year. The airline had a debt-to-capital ratio of nearly 92% at the end of 2000, while anything above 50% is considered unhealthy. US Airways has been hurt further by the indefinite shutdown of Ronald Reagan Washington National Airport near Washington, where it had been the biggest carrier. America West, which came back from bankruptcy a decade ago in the last recession, also getting dragged down by a millstone of debt and had less than \$100 million in cash and credit before the bailout. Neither airline would comment on its financial condition. But Peter Walsh, chief of Mercer Management Consulting's aviation unit, predicts: "Even with this aid package, there still will be bankruptcies."

HIGH-RISK INSURANCE. Continental Airlines Inc. and Northwest Airlines Corp. are in slightly less trouble before the rescue. If the airlines had remained sound, Continental had enough cash to survive for only 39 days, according to Lomon Smith Barney Inc. Northwest's debt ratio was 96%. But analysts say the money and loan guarantees likely will see them through the next few months, and both could regain altitude quickly next year if traffic comes back as expected. Already, No. 4 Northwest says

its flights are more than 50% full, a big improvement over the nearly empty planes after flying resumed, though far from the 65% to 70% that airlines need to break even.

Even AMR, parent of American Airlines and Trans World Airlines, and UAL had seemed vulnerable. While they rank first and second in the world in traffic, the airlines faced ruinous claims if they had been forced to reimburse people and businesses for losses on the ground when the hijackers crashed their planes. But Congress

shielded them from those liabilities.

The handouts will go a long way toward patching the financial hole that the terrorists tore in the industry. AMR will receive the most aid, an estimated \$915 million, followed by UAL, at \$804 million. No. 5 Continental gets \$396 million, while American Trans Air Inc., which ranks 10th, will get \$51 million. All told, passenger airlines will get an estimated \$4.5 billion, while cargo-only carriers will receive \$500 million.

Still, the airlines don't expect a rapid return to normal traffic levels. Aside from Southwest Airlines Co., the major carriers have announced service and payroll cuts of roughly 20%. Altogether, the industry is expected to shuck

110,000 employees and up to 900 no-longer-needed planes, as airlines downsize to levels of the mid-1990s. Most of the planes will be parked in deserts in the West. Even before the hijackings, four small carriers had filed for Chapter 11 protection; one, Midway Airlines Corp., has shut down.

PLUNGING TICKET SALES. Eventually, of course, people will return to the skies. Already, there are some signs of normalcy. Southwest is again promoting its low fares on TV, and United has resumed emphasizing ticket sales on its Web site. At Minneapolis-based Carlson Wagonlit Travel, travel agents report few cancellations over the upcoming yearend holidays. And one by one, corporations are lifting their bans on travel.

Still, it took more than a full year for travel to get back to normal following the Persian Gulf War in 1991. And analysts and industry executives say the coordinated hijackings of four jets inside the U.S. could spook travelers for even longer. The Air Transport Assn. forecasts that ticket sales will be off 40% in the fourth quarter and won't rebound to year-earlier levels until next year's third quarter. "There is no business unless people feel secure. Period," notes Philip M. Condit, Boeing Co.'s chairman and CEO.

In some ways, the industry is stronger than it was going into

NEW INVESTOR The airlines get loan guarantees—and the feds get equity

1991, when a war and a recession conspired to drop airlines into the tank. Even before the hijackings, some carriers were speeding up the retirement of old planes, postponing purchases of new ones, and imposing hiring freezes. But the nation's fear of flying is much more intense today than it was a decade ago. And a full-blown recession appears to be just starting. The bailout and the airlines' aggressive cost-cutting should get most of them into the new year. But 2002 will almost certainly bring more financial crisis. Look for the government to be right in the thick of it.

By Michael Arndt in Chicago, with Nanette Byrnes in New York and Lorraine Woellert in Washington

WICHITA: NOT SO FAR FROM GROUND ZERO

Joe Goodwin still has his \$20-an-hour job building 737 parts at Boeing Co.'s sprawling Wichita plant, but he's convinced that his days there are numbered. The 37-year-old production worker, along with the rest of the country, reacted with horror when the twin towers crumbled to the ground on Sept. 11. Now the reverberations of that awful day are shaking up this prosperous Midwestern city.

Although far removed from the physical devastation, Wichita, like so many other places around the country, must now brace itself for the economic aftershocks rippling out in every direction from ground zero. This former cattle town long ago grew into the city with the highest concentration of aircraft workers in the country. That strength, however, has suddenly turned into a huge liability. First, there was Boeing's decision to slash as many as 32,000 jobs by 2002. Now, the city is on edge, waiting to see how its economy will shake as a result, even as other aircraft makers also mull layoffs. Goodwin, for one, isn't optimistic. "Where else," he asks, "am I going to find a job that pays as much as Boeing?"

COLLATERAL DAMAGE. Probably nowhere, at least not in Wichita. Fully 81% of the city's manufacturing jobs—and 21% of the city's total employment—are tied directly to the aircraft and aerospace industries. Talk around the Boeing plant has it that as many as 5,000, or 40%, of Boeing's 17,400 local workforce could be cut. The city's other 43,000 aircraft workers are also at risk. Its three other big aircraft employers, Cessna Aircraft, Raytheon, and Bombardier Aerospace largely make corporate jets. But sales of those craft could fall as corporate profits tumble. Raytheon has already been laying off workers. And Bombardier has warned of coming cuts.

The many smaller local companies that supply parts and services to the big-name manufacturers will also be hard hit. D-J Engineering Inc., a maker of machined aircraft parts, relies on Boeing for much of its business. Should Boeing scale back operations significantly, D-J could be forced to cut as much as one-third of its 150-person workforce. The economy "is just going to get horrific in Wichita," says D-J Chief Financial Officer



AT BOEING Machinist Goodwin is sure his days are numbered

Ronald E. Hipp.

But the cutbacks won't just affect aircraft workers. All of the city's commerce, from the bars and restaurants to the barber shops and retail stores in the shopping plazas, will feel the slump. At Charlie's, a bar and popular lunch spot down the street from Boeing, business is already off 30% since the attacks. "In 17 years, I have never seen a decline like this," says owner Rusty

Young, who wonders whether she will even be able to stay in business beyond November.

Elsewhere in the city, the economic mood is more like the calm before the storm. Many car dealers, retailers, and real estate agents say sales are holding up. In fact, Wichita's unemployment rate ticked down slightly in July, to 3.5%, well below the national average. That could change quickly, though: For every job lost at Boeing itself, two other local jobs eventually disappear, according to Wichita University Economist Janet F. Harrah.

About the only businesses looking forward to the impending gloom are the pawn shops along seedy Oliver Street, which leads to the Boeing plant. Dale Martens, manager of Money Town Inc., expects revenues to surge by 10% to 15% as layoffs mount and unemployed workers pawn items for cash. Joe Goodwin isn't waiting. He's already looking to sell his set of free weights and one of his family's three motorcycles. That's not likely, though, to make much of a dent in their credit-card debt, let alone pay the bills or buy groceries. That's why the Goodwins, along with scores of other Wichita families, are bracing for a long, hard winter.

By Robert Berner in Wichita

TERRORISM'S LONG REACH

With 81% of its 74,000 manufacturing jobs directly tied to the aircraft industry, Wichita is bracing for tough times

LOCAL AIRCRAFT JOBS

BOEING	17,400
CESSNA AIRCRAFT	11,200
RAYTHEON	9,200
BOMBARDIER AEROSPACE	4,100
OTHERS	18,100
TOTAL	60,000

Data: Bureau of Labor Statistics, Wichita State Univ. Center for Economic Development and Business Research

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STANDING TALL Top KBW execs Michaud, Duffy, and Senchak vow to rebuild the operation

INVESTMENT BANKING

HOW MUCH LOSS CAN A FIRM TAKE?

The attack has Keefe Bruyette testing the limits

On Sept. 22, 11 days after the terrorist attack on the World Trade Center, John G. Duffy had to miss the memorial service for his long-time business partner, Joseph J. Berry. It was held at the same time as the funeral mass for his 23-year-old son, Chris.

That agonizing conflict highlights the tough days ahead for Duffy, co-CEO of Keefe, Bruyette & Woods Inc., as he struggles to rebuild the elite investment banking firm once headquartered at Two World Trade Center. "On a personal level," he says, "you rely on other family members and your faith to get through this. Professionally, it's not a whole lot

different. You rely on your other employees, and if they have the right kind of resolve, I think we can rebuild this thing."

Few firms have been so deeply and irrevocably devastated by the World Trade Center attack as KBW. In all, 67 of the firm's 172 New York-based employees died or are still missing. They accounted for nearly a third of KBW's 224 employees. In a stroke, the firm, which specializes in the financial-services industry, lost more than 400 years of professional experience and much of its leadership. Gone are five of nine board members, including KBW's directors of equity trading, bonds, and research, along with its most prominent and influential financial analysts. Those missing or dead were responsible for 40% of KBW's annual revenues, which

reached \$125 million last year. In addition to the human loss, the firm lost its headquarters and every shred of paper documentation that existed there.

The magnitude of KBW's troubles raises questions of how much a single company can lose and still retain a strong enough core to regenerate itself. The survivors are determined to remake the firm and stay in New York. In the midst of incredible stress and trauma, they are forced to make key decisions on almost every front, from choosing new office space to interviewing scores of candidates to rebuilding their operations. If the firm is to resume anything like its old scope, those decisions must be made as quickly as possible. Meanwhile, almost every day brings a new funeral or memorial service. "Nobody's been through anything like this," says Duffy. "There isn't a rule book to tell you what you should or shouldn't do."

EARLIER REBOUND. Until Sept. 11, the firm had been well on its way to a turnaround of sorts. Duffy, 52, and Berry, 55, became co-CEOs 2½ years ago after former CEO James J. McDermott Jr. signed amid an embarrassing investigation into insider-trading charges. McDermott eventually pled guilty to tipping off his mistress to bank mergers the firm was working on. In the past two years, KBW expanded its workforce by some 30% and doubled revenues. In the year's first half, KBW was a key player



The essentials of imaging

As he looked out over the perfectly manicured grass of the driving range at Augusta National, perhaps Sam Snead wasn't really there.

Perhaps, in his mind, he was a kid again, sneaking in a quick three on an overgrown course so steep that it was nicknamed "The Goat Course." Either way, he was swinging like he was a kid.

At 8:35 A.M. on Tuesday, April 3, 2001, Sam Snead stepped onto the range to hit a few balls and to say a few hellos. He ended up putting on a swing clinic.

Few golfers swing sweet enough to make people stop and take notice. Only one can still do it at the age of 89.

As Sam took his place and started to hit, one by one, Palmer, Watson, Faldo and every other pro put their clubs down and gathered around, showing their profound respect and admiration for the greatest swing in golf history.

As ball after ball sailed into the sky, Sam raised his head and watched every ball find a home in that great green expanse of grass.

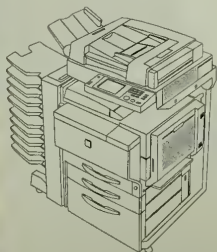
He later admitted that at his age he couldn't see exactly where they landed. But he didn't need to.

"All I saw was green. But I could *feel* they were all good."

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*green
by sam
snead*

21 bank and thrift mergers, more than any other I-banker.

That rebound is a testament to the firm's tightly knit culture. Many staffers had worked together for decades. Turnover was exceptionally low. KBW's policy of not paying commissions kept the culture from being cutthroat. Some 130 of the 224 staffers are shareowners of the privately owned firm. "The business will regenerate itself almost organically or naturally," says Vice-Chairman Andrew M. Senchak. "The hard part is going to be the emotional toll on individuals and social relationships."

Since the attack, the firm's survivors have been working out of borrowed space in midtown Manhattan, struggling to keep up with the flow of business and trying to come to grips with the loss of life. Some operations are now housed in cluttered conference rooms at its law firm, Wachtell, Lipton, Rosen & Katz, while the trading desk is at a client bank, BNP Paribas. Other New York-based employees are working from KBW's offices in Hartford and Boston.

NO RETURN. The issue of office space is disheartening because the firm moved into lavishly refurbished quarters a year-and-a-half ago. Its new offices on the 88th and 89th floors in Tower Two, a few floors up from its old digs, were a symbol of sorts—of the stature the firm had attained and its aspirations for the future. Now it hopes to find space for a year or two while it looks for permanent quarters. Duffy and Senchak started looking almost immediately. They are open to any midtown neighborhood. Downtown is off limits. Duffy says KBW will never return to the financial district, even though it will have to pay nearly twice the \$34 per square foot it paid in the World Trade Center.

The real estate problem pales in comparison to the personnel issues. Although the firm's engineers had the computer systems up and running in time for the market's reopening on Sept. 17, KBW waited an extra day before trading. "The systems were ready, but the people weren't," says Thomas B. Michaud, executive vice-president for equity sales. To keep the firm going, KBW's leadership has reshuffled its remaining employees to plug some gaps. But Duffy says its equities-trading desk is probably operating at no more than 25% of its previous capacity, while research is at something less than half. Senchak fears the increased workload, combined with the emotional fallout, could cause some employees to break.

Yet many seem emboldened to move forward. "I don't think we should bow down and let anyone take this away

from us," says Joseph Berry Jr., 27, an investment banker whose father, the co-CEO, was killed in the attack. "A lot of the junior people here are being asked to step up, and we will."

Duffy also is hopeful that the firm can recruit newcomers from the ranks of Wall Street's unemployed and lure small teams out of the larger brokerage houses to restock its decimated trading desk and research department. Two weeks after the disaster, KBW began scheduling interviews with job candidates. It's a huge job, and KBW knows it doesn't have the luxury of time. "Over 40 years, we think we've built up enough goodwill in the marketplace that

KEEFE, BRUYETTE & WOODS

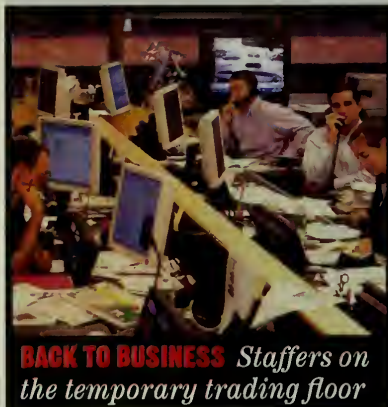
Brokerage and investment-banking boutique for the financial-services industry

ANNUAL REVENUES \$125 million

FORMER HEADQUARTERS 88th and 89th floors of World Trade Center's South Tower

EMPLOYEES BEFORE TRAGEDY 224

DEAD OR STILL MISSING 67 of 172 New York-based employees, including the chairman and co-CEO, as well as directors of research, equity trading, and fixed income



our clients will give us time to come back," says Michaud. "I think we have at least two months."

It's still too early to estimate the financial impact. Some \$23 million in insurance coverage may offset a good deal of the losses, including the \$18 million it cost KBW to renovate and furnish its Trade Center offices. Meantime, KBW says the lull in the economy actually helps it—there are fewer deals to lose.

Tougher still is how to lessen the emotional trauma of the survivors and

the families. Many of those trapped in the doomed building spent their last minutes describing their harrowing circumstances to loved ones by phone. Kevin Szocik, 27 and recently promoted to vice-president, reached his mother in Massachusetts on his cell phone. He said he was calling from a stairwell. He had made it down seven floors from his office but said the smoke had become impossibly thick. "I can't see anything," he said. The line then went dead.

HORROR. Employees who made it out witnessed unimaginable horror. Lauren Smith and Linda Rothenmund were in an elevator with colleagues Dean F. Eberling and Russell Keene III when the second plane crashed into their building. Immediately, the elevator went into a free fall for some 15 floors. With the doors jammed shut and flames lapping at the elevator floor, they escaped after the men shoved them through a six-inch gap where the wall and floor of the damaged elevator had separated, an opening too narrow for the men. Minutes after the women reached the plaza outside, the tower collapsed.

In the immediate aftermath of the disaster, KBW assigned two of its senior officers to counsel affected families. It hired an outside counseling firm to offer guidance to employees and relatives and set up a suite at the Plaza Hotel for grieving families to take refuge. The firm is still paying the salaries of its missing employees, who also have company-provided life insurance of up to \$200,000 each. A KBW Family Fund has been established to provide financial assistance to victims' families.

The day after the attack, a few employees gathered in the Wachtell office to put the firm back together. It was pure bedlam. The group was inundated by phone calls from relatives of missing employees, friends, and concerned clients. Then, a cleaning woman from the firm's old offices, Paula Scantlebury, showed up and began fielding calls and taking messages. "She became the emotional center," says Senchak. "Other people have coped much differently. A lot of people haven't been able to come back yet. Some of these kids are babies, or two or three years out of college. They've seen some horrible things."

Can the firm make it back? The survivors think so, if only because they're motivated to make sure the firm's stock retains its value for the grief-stricken families of their fallen colleagues. "I just couldn't walk away from the rest of the people or what has been my lifeblood," says Duffy. "I'm not ready to hang up." Neither are his colleagues.

By John A. Byrne in New York



People issues are complex. Managing them doesn't have to be.

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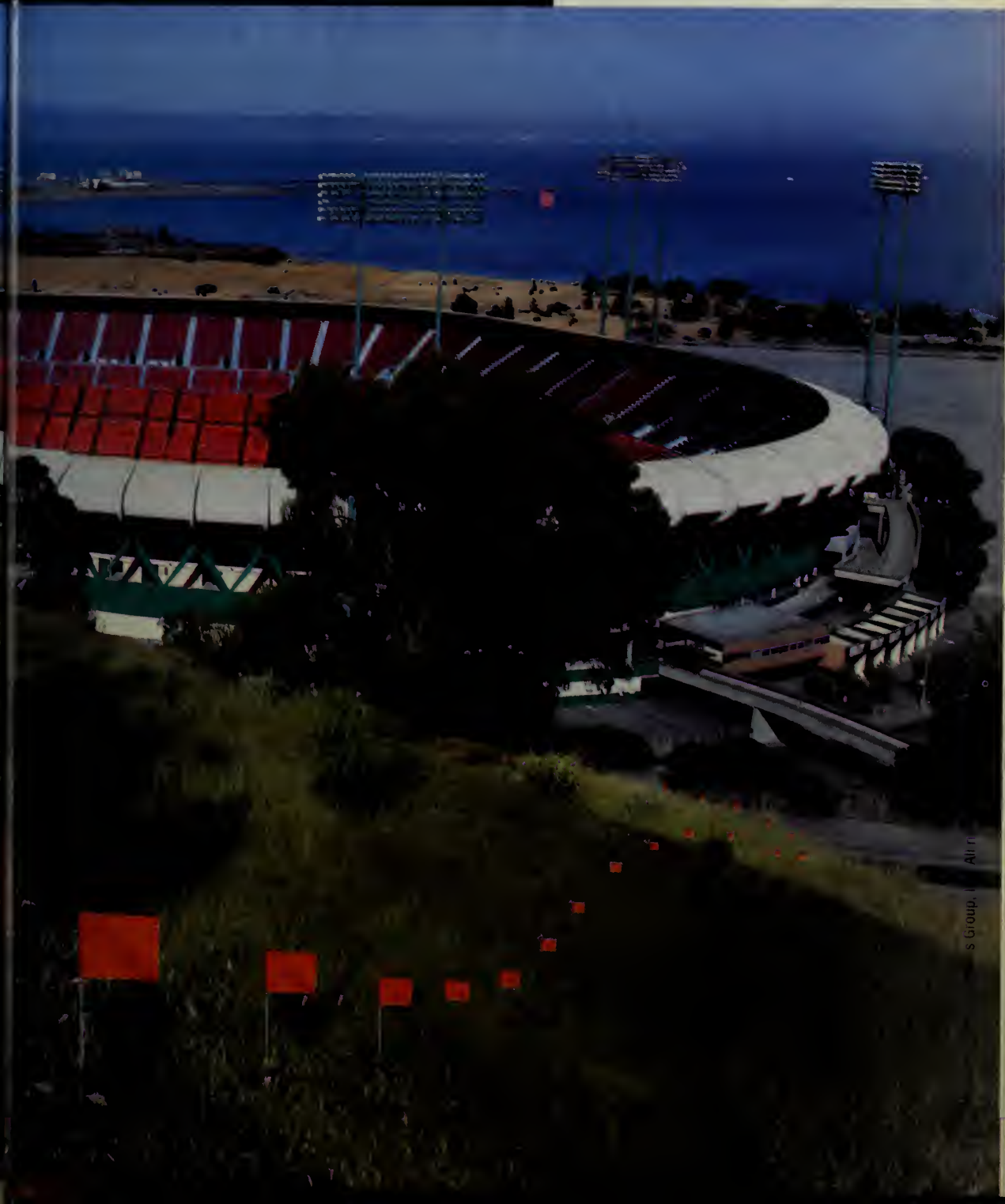
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THE WORST MAY NOT BE

With mutual funds hit hard, it's time to fine-tune—not bail out

Mutual-fund investors have taken their knocks lately. The speculative excesses and lure of high-flying tech and growth stocks are behind them, but their toughest test of wills may still lie ahead. The new hurdles: an accelerated decay in corporate earnings, an economy slumping towards recession, and new global political tensions roiling the financial markets. So far, investors have chosen the path of least resistance: "It's a Zen thing," says Daniel G. Bandi, co-manager of the \$700 million Armada Small Cap Value Fund, who saw his heady 11% gain through August turn into a 4.2% decline by Sept. 24. "You just have to go along for the ride."

While no one is urging investors to panic and liquidate their stock and mutual-fund holdings, the time for crisis-proofing investments has come. Most investors still hold far too many richly priced securities—even after a bear market that began in the spring of 2000. And like professional money managers, they should consider lightening up their stock funds in favor of bond funds and maybe buy a "bear" fund to hedge risk, beef up on dividend-paying securities, and—in the words of billionaire investor Warren E. Buffett—never forget that the dumbest reason to



HUNKERING DOWN

Smart money managers plan to ride out the storm by:

- Buying dividend-producing stocks, such as real estate investment trusts
- Favoring value stocks or cheap securities with strong balance sheets
- Leaning toward smaller and mid-size companies instead of large-cap blue chips
- Stocking up on beaten-down sectors, such as brokerage, insurance, and airline stocks
- Lightening up on technology and telecom sectors

Data: Standard & Poor's

buy a stock or mutual fund is because it's going up.

Perhaps the most disheartening prospect is that there's no sense that values will stop falling. Frederick B. Taylor, chief investment officer at U.S. Trust Corp., believes that recent events won't impose a lasting drag on the markets. "[That] doesn't mean that the worst is over or behind us, or that we've necessarily seen the lows," he says. "We're going back to where investors must understand the risk-and-return relationship."

Investors will get a sharp reminder that lesson when quarterly fund and 401(k) statements begin to arrive in the mail. The damage to mutual-fund portfolios during the third quarter is extensive: The average U.S. diversified fund shed 19.6% through Sept. 24 (table), the worst quarterly performance since 1980. Only one category of fund, precious metals, is in the plus column: up a scant 0.67% after being a losing proposition for most of a decade. Real estate and international hybrid funds are the other two groups that managed mere single-digit losses. Value and growth funds, whether large-, mid-, or small-cap, have lost from 14.4% to 28.5% in the past three months. That compares with a 18% drop in the Standard & Poor's 500-stock index. International stock funds are down about as much as o

VER



estic ones, while emerging-markets funds, perhaps the riskiest of the bunch, lost 22.7%, about the same as the developed country funds.

Year-to-date losses for the average U.S. diversified equity fund have now ballooned to 25%, compared with a 1.3% loss for all of last year. Even value funds—whose staunchly conservative managers buy undervalued stocks—didn't resist the trend: The small-cap variety, up a nifty 9.5% in the second quarter, fell 18.5% in the third.

For many investors, these results mean that their long-term investment horizon just got a lot longer. Says John Brennan, president of Vanguard Group Inc. in Malvern, Pa.: "We're going through a rough wrenching change, but you could have had a perspective longer than a day or quarter," he says. The

stock market, is purging the excesses built up during the long bull market. Once they're gone, he says, "you can be bullish for the next 10 years."

That doesn't mean investors can expect a return to triple-digit gains, reminiscent of bubble-happy days of old. Nowadays those are the domain of bear-market funds that bet on falling stock prices. Nearly half the 50 top-performing equity funds use hedging strategies, such as selling stocks short. But even managers of such funds are circumspect about tooting their horns: "We are not marketing these funds for the doomsayers as much as we are to hedge risk," says Charles J. Tennes, portfolio director at Rydex Funds. "To make use of short funds, you combine them with other long-term funds and moderate your exposure; you don't just play the direction of the market."

NO RUSH. Waiting out downturns has paid off for the past 20 years—as markets have always rebounded. And, so far, there's no evidence of widespread defections from funds. Robert Adler of AMG Data Services, an Arcata (Calif.) firm that tracks fund flows, calculates that \$5.9 billion left equity funds in the six business days ended Sept. 19—that is, the three days before the terrorists struck and the three days after the market reopened. That amounts to less than 0.5% of all equity mutual-fund assets. Adler says the last time

there was a comparable outflow was mid-March, when investors yanked \$6 billion from stock funds. "I was impressed that net cash redemptions weren't larger," he says, adding that some bond funds and money-market funds had record inflows. That's partly because financial planners and mutual-fund complexes have been preaching the stand-pat axiom. Robert H. Moody of Compass Advisors LLC in Atlanta has tweaked his clients' portfolios toward short-term bond funds, as well as value and small-cap funds. An investment plan "does not change with current events," he says.

Wholesale dumping of stocks is rarely prudent. But jittery investors who have sold opened up new doors for professional investors previously waiting in the wings. Consider the deep-value

How the Big Funds Fared

FUND	NET ASSETS BILLIONS	TOTAL RETURN*
FIDELITY MAGELLAN	\$78.8	-18.50%
VANGUARD 500 INDEX	72.3	-17.82
INVESTMENT CO. OF AMERICA A	53.9	-13.07
WASHINGTON MUTUAL INVESTORS A	48.2	-10.99
FIDELITY GRDWT & INCOME	34.3	-13.52
GROWTH FUND OF AMERICA A	34.3	-22.37
FIDELITY CONTRAFUND	32.9	-13.38
NEW PERSPECTIVE A	28.2	-18.00
EURDPACIFIC GRDWT	27.9	-17.06
JANUS	27.8	-27.77

How the Fund Groups Fared

CATEGORY	TOTAL RETURN*
PRECIOUS METALS	0.67%
REAL ESTATE	-7.99
INTERNATIONAL HYBRID	-8.34
DOMESTIC HYBRID	-10.17
UTILITIES	-12.20
CONVERTIBLES	-12.34
MID-CAP VALUE	-14.35
LARGE-CAP VALUE	-15.11
FINANCIAL	-15.46
SMALL-CAP VALUE	-16.17
HEALTH	-17.60
LARGE-CAP BLEND	-17.82
SMALL-CAP BLEND	-17.83
MISCELLANEDUS	-18.14
EURDPE	-18.33
NATURAL RESOURCES	-18.41
FOREIGN	-19.22
MID-CAP BLEND	-20.01
ALL CAP	-20.15
DIVERSIFIED PACIFIC/ASIA	-21.34
LARGE-CAP GRDWT	-21.61
JAPAN	-21.96
DIVERSIFIED EMERGING MARKETS	-22.70
PACIFIC/ASIA EX-JAPAN	-23.49
SMALL-CAP GRDWT	-25.85
MID-CAP GRDWT	-28.54
COMMUNICATIONS	-29.15
LATIN AMERICA	-26.44
TECHNOLOGY	-35.87
S&P 500 (WITH DIVIDENDS)	-17.83
U.S. DIVERSIFIED FUNDS	-19.60
INTERNATIONAL EQUITY FUND AVR.	-19.73

*Appreciation plus reinvestment of dividends and capital gains before taxes, July 1 through Sept. 24, 2001

Data: Standard & Poor's

Aegis Value Fund, which buys only stocks with single-digit price-earnings ratios. The fund is up 26% this year and has been rushed by a surge of performance-hungry investors—who pushed assets to \$23 million from \$6 million in June. But co-manager Scott Barbee didn't cut his 40% cash position by half until September. (The average U.S. fund manager has a 5.9% cash stake, up from 5.2% this time last year, reports Morningstar Inc.) "We weren't in a big hurry to buy stocks before because small-cap managers had aggressively bid up prices," he says. "But I feel more positive now about overall valuations than I have in many months." One stock he scooped up prior to the World Trade Center catastrophe was Allied Research Corp. Although the company happens to make mortar shells, it also carries \$20 million in cash on its balance sheet, boasts no debt, and sold at just eight times earnings. No surprise, the stock subsequently doubled. Allied, at 5% of the fund, is now Barbee's biggest position.

SOLID NICHES. Robert A. Olstein, portfolio manager of the \$500 million Financial Alert Fund, has socked away 20% of his fund's assets in cash since 1999. He's now left with only 4% cash after a spree of buying brokerage stocks—Merrill Lynch, Goldman Sachs, and Morgan Stanley—which he expects to rebound in the coming year. While financial-sector mutual funds have slid 15.5% in the third quarter, neither the intrinsic values of financial companies nor the demographics of their aging baby-boomer customers have changed. Olstein expects that once the "doom-and-gloom of the mood has passed," investors will regain faith in the U.S. markets: "Where else are they going to put their money?" Even battered airline and insurance stocks surfaced as prime buy candidates for some managers. In the past few weeks, Nicholas D. Gerber of Ameristock Focused Value Fund has boosted his position in Midwest Express Airlines from 5% to 15% of the fund and has doubled his holding in KLM Royal Dutch Airlines to 10%.

Some fund managers have shown almost clairvoyant prowess in picking stocks. Just look at David A. Corbin of Fort Worth. The top four long-term holdings in his Corbin Small-Cap Value Fund have eerily benefited since the Sept. 11 attacks, even though they are years old. The fund's top position is Titan Corp., an electronic-defense company that builds surveillance equipment. No. 2 is Forgent, a videoconferencing company, poised to get a lift from trav-

The Best Mutual Funds

FUND	TOTAL RETURN*	FUND	TOTAL RETURN*
RYOEX DYNAMIC VENTURE 100	109.81%	SCHROOER ULTRA	4.59%
PROFUNDOS ULTRASHORT OTC PROFUNO INV.	109.62	HUSSMAN STRATEGIC GROWTH	4.02
RYOEX ARKOTS INV.	48.55	USAA GOLO	3.97
PROFUNDOS ULTRABEAR PROFUNO INV.	46.07	RYOEX PRECIOUS METALS	3.85
RYOEX DYNAMIC TEMPEST 500	45.13	INVESCO GOLO INV.	3.68
POTOMAC OTC SHORT	44.46	MIOAS	3.41
PRUOENT BEAR	41.03	PILGRIM PRECIOUS METALS A	3.03
COMSTOCK CAPITAL VALUE A	32.33	CENTURION COUNSEL MARKET NEUTRAL C	2.99
POTOMAC SMALL CAP SHORT	27.95	SCUOER GOLO	2.96
RYOEX URSA	22.30	O'HIGGINS	2.64
PROFUNDOS BEAR PROFUNO INV.	22.18	PHOENIX-EUCLIO MARKET NEUTRAL A	2.16
AXA ROSENBERG VALUE MKT. NEUT. INV.	21.72	AETNA PRINCIPAL PROTECTION 2 A	2.01
POTOMAC U.S. SHORT	20.16	PURISIMA PURE AMERICAN	1.83
COMSTOCK STRATEGY O	14.27	WELLS FARGO INCOME PLUS A	1.77
AXA ROSENBERG SEL. SECTORS MKT. NEUT. INV.	13.67	MIDAS INVESTORS	1.49
PURISIMA TOTAL RETURN	8.26	EVERGREEN PRECIOUS METALS HOLOINGS A	1.32
PURISIMA PURE FOREIGN	7.78	GABELLI GOLO	1.14
MONTEREY OCM GOLO	7.52	AETNA PRINCIPAL PROTECTION 1 A	1.02
PROACTIVE ASSET ALLOC. OPTI-FLEX DYNAMIC	7.35	FIFTH THIRO STRATEGIC INCOME IS.	0.97
FIRST EAGLE SOGEN GOLO	7.02	FEDERATED MANAGED INCOME INSTL.	0.73
AMER CENTURY GLOBAL GOLO INV.	6.86	DIVERSIFIO INV. SHORT HORIZON STG. ALLOC.	0.64
CREDIT SUISSE W.P. LONG SHORT MKT. CMN.	5.84	GABELLI INVESTOR ABC	0.31
BOSTON PARTNERS LONG SHORT EQUITY INV.	5.29	FIDELITY SELECT FOOD & AGRICULTURE	0.23
VAN ECK INTL. INVESTORS GOLO A	5.06	CALAMOS MARKET NEUTRAL A	0.15
ISHARES MSCI MALAYSIA INOEX	4.86	HUOSON INVESTORS	0.00

And the Worst

FUND	TOTAL RETURN*	FUND	TOTAL RETURN
FIRSTAR EQUITY INOEX Y	-76.53%	MUNOER NETNET A	-44.83%
FIRSTAR BALANCED GROWTH INSTL.	-63.59	BERGER NEW GENERATION INV.	-44.43
PROFUNDOS ULTRAOTC PROFUNO INV.	-60.35	RED OAK TECHNOLOGY SELECT	-44.08
BERKSIRE FOCUS	-54.92	TURNER TECHNOLOGY	-43.61
BERKSIRE TECHNOLOGY	-54.52	IOEX MUNDER NET50 A	-43.6
BLACK OAK EMERGING TECHNOLOGY	-54.31	FIRST AMERICAN TECHNOLOGY Y	-43.38
AMERINOO TECHNOLOGY A	-53.24	MS SMALL CAP GROWTH O	-43.12
VAN WAGONER MID CAP GROWTH	-53.22	J HANCOCK TECHNOLOGY A	-42.97
POTOMAC INTERNET PLUS	-52.74	TCW GALILEO SMALL CAP GROWTH I	-42.96
VAN WAGONER TECHNOLOGY	-51.76	FIRSTNANO E COMMERCE	-42.78
VAN WAGONER EMERGING GROWTH	-51.63	POTOMAC OTC PLUS ADV.	-42.68
VAN WAGONER POST VENTURE	-51.42	WWW INTERNET	-42.66
STREETTRACKS M.S. INTERNET INOEX	-51.39	PIMCO INNOVATION A	-42.62
ISHARES O.J. U.S. INTERNET INOEX	-51.23	M.S. TECHNOLOGY A	-42.57
J.P. MORGAN H&Q GLOBAL TECHNOLOGY A	-50.96	ING GLOBAL COMMUNICATIONS A	-42.55
INVESTEC INTERNET.COM INDEX	-50.74	ASAF PROFUNO MANAGED OTC B	-42.47
MERRILL LYNCH FOCUS TWENTY B	-50.16	BERGER MID CAP GROWTH	-42.17
AMERICAN HERITAGE	-50.00	WILLAMETTE TECHNOLOGY	-42.16
OPPENHEIMER MERCURY ADV. FOCUS GROWTH Y	-49.37	CALVERT TECHNOLOGY A	-42.15
MONUMENT DIGITAL TECHNOLOGY A	-48.46	ALPHA ANALYTICS DIGITAL FUTURE	-41.93
JACOB INTERNET	-48.39	VAN KAMPEN TECHNOLOGY A	-41.89
ING INTERNET C	-48.34	ING GLOBAL INFO TECHNOLOGY A	-41.87
FRONTIER EQUITY	-47.59	WM SMALL CAP STOCK A	-41.76
OELAWARE TECH. & INNOVATION INSTL.	-46.58	PIMCO GLOBAL INNOVATION A	-41.66
CONSECO SCIENCE & TECHNOLOGY Y	-44.95	MFS TECHNOLOGY A	-41.20

*Appreciation plus reinvestment of dividends and capital gains before taxes, July 1 through Sept. 24, 2001

Data: Standard & Poor's

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el-wary executives, while No.3, medical-device maker Cyberonics Inc., is exploring treatments for psychiatric disorders, such as depression. The fund's fourth-largest stake is in Thomas Nelson Inc., the largest Bible publisher. "We have a number of niche businesses that are benefitting from the chaos, but clearly we didn't know this was going to happen," says Corbin. "We bought these companies because they have very solid fundamentals."

"RUDE AWAKENING." The quarter's biggest losses, no surprise, have been sustained by tech and telecom funds. Kevin Landis, fund manager of the Firsthand Technology Leaders Fund, has lost 38.5% this quarter, but he says most of his investors are staying put: "It's a little late to sell at the top, so the best alternative is to stick it out," he says. Others disagree. Says Peter B. Doyle of Kinetics Asset Management, "The typical investor who is still looking to Dell, Cisco, and Intel as good investments is in for a rude awakening. The valuations are still high."

Some managers are even more wary. Charles Minter's Comstock Strategy, an international hybrid fund he runs for Gabelli Funds Inc., hasn't owned a single U.S. stock since 1997. The fund is up 19.2% year to date, after losing money in the last five years of the bull market. "Our bearishness has nothing to do with terrorist attacks," says Minter. Looking back to the 1974 market bottom when the S&P 500 index sold at eight times earnings, vs. 22 today, he forecasts that the index could fall another 25%. "We can't possibly be giving advice to stay put and don't worry about it," he says. "When you have a bubble like the one you just had, you're more than likely not going to stop at normal valuations. You're going to the trough." On an upbeat note: Minter is formulating a buy list, though he's not made a move yet.

Size has offered some protection. Only two of the 10 largest equity funds had lost more than the S&P this year through Sept. 24, though there were still losses in the double-digits. "I think that people have to understand that these losses do occur," says Daniel P. Wiener, publisher of *Independent Advisor*, a newsletter that tracks the Vanguard funds. "If the managers are consistent they will come back, but you have to stick with it."

Staying the course isn't necessarily bad advice. But in these uncertain times it will take nerves of steel.

By Mara Der Hovanesian
in New York

BONDS

THE SUDDENLY SEXY... GOVERNMENT BOND

Compared with equities, bond-fund returns look bountiful



HEATING UP: Treasury bond action at the Chicago Board of Trade

Bond funds are boring? No longer. Those investing in rock-solid, short-term U.S. government issues produced an average total return of 2.39% in the third quarter through Sept. 24—a stellar performance compared with the 19.6% loss by the average diversified equity fund. Returns at funds investing in long- and intermediate-term government paper did even better, racking up returns of 3.8% and 3.76% respectively, according to data compiled for *BusinessWeek* by Standard & Poor's, both

part of The McGraw-Hill Companies.

Now the key question is how much potential for superior returns bonds have left. Investors certainly think there's plenty. After the Sept. 11 attack, they poured money into short-term Treasuries, pushing yields to levels not seen since the early 1990s as plumping the returns of funds specializing in such issues by three-quarters of a percentage point. It was a continuation of a love affair that has been running all year: In the first seven months of 2001, invest-

HUNTING FOR BOND RETURNS

Fearing the runoff in short-term bonds may be ending, some managers are repositioning

- Shifting to medium- and longer-term government issues
- Buying top-grade corporate bonds
- Dipping into junk bonds selectively

Data: Standard & Poor's

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delivered three
generations of babies.*



*Kathleen Hastings
Schwab Investment Specialist,
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poured net new cash of \$44.7 billion into bond funds—a complete reversal from the same period last year, when they yanked out \$40.5 billion, according to the Investment Company Institute.

While investors favor the safety of very short-term government issues, which have the lowest risk of loss, many of the pros who live and breathe bonds are beginning to change their strategy and move into longer-dated issues. Their reasoning: The rally in short-term debt has about run its course. For instance, William H. Gross, doyen of the bond world, who manages \$233 billion in bonds for PIMCO Investments, recently sold the bulk of his short-term government notes, buying medium-term governments instead. It's called moving up the yield curve. Short-term interest rates have fallen much faster than longer-term rates following the Federal Reserve's series of rate cuts, meaning that the yield curve, which plots the rates available on different maturities, has steepened—giving better running yields on longer bonds than short ones, as well as a chance for bigger capital gains if longer-term interest rates start to fall.

Even as some professionals move out

How The Bond Funds Fared

CATEGORY NAME	TOTAL RETURN*	CATEGORY NAME	TOTAL RETURN*
LONG GOVERNMENT	3.80%	MUNI. NATIONAL LONG	2.32%
INTERMEDIATE GOVERNMENT	3.72	MUNI. NATIONAL INTERM.	2.23
INTERNATIONAL BOND	3.33	MUNI. SINGLE-STATE INTERM.	2.03
INTERMEDIATE (GENERAL)	3.22	MUNI. NEW YORK INTERM.	1.97
MUNI. CALIF. LONG	3.19	MUNI. NEW YORK LONG	1.94
LONG (GENERAL)	2.65	MUNI. HIGH-YIELD	1.91
SHORT (GENERAL)	2.56	MUNI. SHORT	1.32
MUNI. CALIF. INTERM.	2.45	ULTRASHORT	1.10
SHORT GOVERNMENT	2.39	HIGH-YIELD	-4.24
MUNI. SINGLE-STATE LONG	2.33	EMERGING MARKETS BOND	-4.57

*Appreciation plus reinvestment of dividends and capital gains before taxes, July 1 through Sept. 24, 2001

Data: Standard & Poor's

of shorter-term bonds, others are moving in because they were in near-cash instruments such as money-market funds, which are now yielding a record low 2.55%. "With [money-market] yields getting down pretty low, we expect to be able to squeeze out at least another percentage point or two" by investing in short-term corporate- or government-bond funds, says Charles E. Foster, an independent financial planner with Blankenship & Foster in Del Mar, Calif. That's certainly been possible so far this year. Between Jan. 1 and Sept. 24, a \$10,000 investment in the average short-term government bond on Jan. 1 would have returned \$579 through Sept. 24, vs. \$302 from the average taxable money-market fund.

Even managers who focus on intermediate-term bonds have been taking a longer view lately. Consider Rajiv Sobti, co-manager of the Black Rock Government Income Portfolio. Sobti's intermediate-bond fund is one of the best performers in the government bond arena, sporting a 15% gain in the past year—far surpassing even the average equity fund. It's third-quarter 5.89% total return also ranks it among the best

of breed. But Sobti believes that two-year U.S. Treasury notes, which recently yielded 2.5%, will eventually fall to between 2% and 2.25%, so he's tweaking the portfolio with longer-term securities. Lately, he has been buying mortgage-backed securities with five- and 10-year durations from Freddie Mac and Fannie Mae.

DOMESTIC RISK. Diversification in turbulent markets is critical, even for bond investors. Plunking everything into U.S. Treasuries can expose investors to domestic risk. With that in mind, international options merit a look. Many have fared better than their U.S. counterparts: As a whole, the group returned 3.33%. The A-list includes the Stroh International Bond Fund, up 9.41% in the third quarter through Sept. 24; the Brinson Global Bond Fund, up 7.35%; and the Lord Abbett Global Income Fund, up 6.23%. While the managers of these funds mainly invest in foreign government debt, they have also gotten a boost from the currency appreciation.

If there is any appetite for risk among bond investors—or a penchant for contrarian thinking—they might consider dabbling in high-yield junk bonds. Jim Kelso, portfolio manager of the Morgan Keegan High Income Fund, sees "the best opportunities in high yield in years," and investors could see returns in six to nine months.

However safe bond funds may seem compared with equities, they're not so static. Investors need to stay on top of fast-moving bond-market dynamics.

By Geoffrey Smith in Boston

The Bond Fund Leaders

TAXABLE FUNDS

	TOTAL RETURN*
FIRSTAR AGGREGATE BOND RETAIL A	12.02%
FIRSTAR SMALL CAP INDOX RETAIL B	9.76
STRONG INTERNATIONAL BOND	9.41
AMERICAN CENTURY INTL. BOND INV.	8.54
MUNDOER INTERNATIONAL BOND A	7.77
MS INSTL. INTL. FIXED INCOME	7.64
CONSULTING GROUP CAP. MKTS. INTL. FIXED INCOME	7.54
BRINSON GLOBAL BOND I	7.35
SEI INTERNATIONAL FIXED INCOME A	7.17
T. ROWE PRICE BOND	7.14
ALL TAXABLE BOND AVERAGE	1.28

TAX-FREE FUNDS

	TOTAL RETURN*
FIRSTAR NATL. MUNI BOND RETAIL A	10.65%
EATON VANCE NATL. MUNICIPAL B	7.41
SAFECO CALIFORNIA TAX FREE INCOME	4.64
LORD ABBETT CA TAX FREE INC. A	3.98
EATON VANCE CA MUNICIPAL B	3.97
PARNASSUS INCOME CA TAX EXEMPT	3.88
SELIGMAN MUNICIPAL CA QUALITY A	3.84
FIRST INVESTORS MULTI-STATE INS. TAX FREE CA A	3.83
DELAWARE TAX FREE CA INS. A	3.77
NUVEEN FLAGSHIP CO MUNI BOND R	3.74
ALL NON-TAXABLE BOND AVERAGE	2.28

*Appreciation plus reinvestment of dividends and capital gains before taxes, July 1 through Sept. 24, 2001

Data: Standard & Poor's

International bond funds are also worth a look. Many have done better than their U.S. counterparts

"America was not built
on fear.
America was built
on courage,
on imagination and
an unbeatable
determination
to do the job at hand."

Harry S Truman

January 8, 1947





WELCOME TO THE FRYING PAN, JEFF

Can GE's Immelt deliver the double-digit returns he promised?

Tuesday, Sept. 11, was Jeffrey R. Immelt's third day as chairman and CEO of General Electric Co. Early that morning, before a planned address to Boeing Co. engineers in Seattle, he was working out at his hotel when the TV over his Stair-Master flashed the news about the World Trade Center attacks. Within minutes, Immelt was on the phone to GE headquarters in Fairfield, Conn., checking on employees (two died in the attacks) and dispatching GE's mobile generators and medical diagnostic equipment to the disaster scene. The next day, he made a \$10 million company donation to the families of rescue workers lost in the buildings' collapse.

When the stock market reopened six days later, however, it was clear that the 45-year-old CEO was faced with yet another challenge: restoring GE's battered stock price. By week's end, investors had lopped more than 20% off GE shares, while the Dow Jones industrial index had slid only 14.3%. That took about \$80 billion off GE's market cap and put the share price of the world's most valuable company at a level not seen since 1998.

Immelt already had the tough task of convincing the world that he was a worthy successor to the iconic Jack Welch. Now he also has to lead GE through dark and unpredictable times. Not only are customers and employees traumatized by the attacks, but many GE businesses—including jet engines, aircraft leasing, broadcasting, and reinsurance—



“Probably the only good thing about the last few weeks is that I don't get asked about Jack anymore”

— JEFFREY IMMELT

will feel the pain. The company's Employers Reinsurance unit, for example, which provided coverage for some of the hijacked jets, already expects a \$600 million pretax loss this year, while NBC is expected to take a \$50 million hit to profits because of several days of ad-free coverage of the attacks.

Yet on Sept. 21, Immelt appeared before a group of investors and ana-

lysts in Manhattan with surprisingly good news. He promised that profits would grow by 11% this year and that he would deliver double-digit growth in 2002, compared with the usual 15% rate. That means earnings of \$1.41 per share in 2001, only 4¢ less than GE expected before the attacks—2¢ from insurance losses and a cent each from shrinking sales at aircraft engines and various economically sensitive businesses.

How would he do it? Immelt says

strong growth in the company's power-systems, medical-systems, and capital-services units will compensate for weaker earnings. Mix those performers with an expected \$400 million boost in military sales and the company's continual cost-cutting, he argued, and GE will do well. Even NBC is expected to get a \$600 million revenue boost from Salt Lake City Olympics next year. As Immelt put it: “All of our business plans were based on there being an economic slowdown through 2002.”

JAPANESE EXPOSURE. Nevertheless, it won't be that easy. GE probably counts on top-notch performances from its strong units, Power Systems, Medical Systems, which should easily increase earnings next year, by more than 20%, thanks to steady orders and new products. Together, they should account for about a third of GE's operating income. GE Capital Services, the company's finance arm, contributes about 40% of income, is another major unit. Robert Friedman, an analyst at Standard & Poor Corp. (a sister company, *BusinessWeek*) is skeptical

that the unit can deliver the promised 20% earnings growth. Not only does it face tough times in its aircraft leasing unit and the overall economy, it has to cope with Japan's poor economy, which has consumer and business-finance difficulties. Immelt counters that there are bright spots. Lower interest rates should aid financing activities, while lower commodity prices may fuel more acquisition



He had a great strategy. So what happened?

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8 0 0 . 9 2 2 . 7 9 7 9



Because a good plan is a terrible thing to waste.

The Corporation

GE Capital. But he can't let that unit get so big it reshapes GE's image as a well-diversified company.

So far, investors seem to agree with Immelt's optimistic outlook. GE stock rose 3% on Sept. 21, despite another down day for the market, and jumped more than 13% to close at \$35.50 on Sept. 25. It helped that the new chief gave a more detailed analysis of the numbers than Welch normally did. GE's sheer breadth of business is a buffer against bad times. In total, the attacks were projected to trim only several hundred million dollars off the bottom line of a company that racked up \$130 billion in sales and \$12.7 billion in profits last year. And GE's costs were already shrinking. Ongoing efforts in all its divisions to put more operations online should save about \$1.5 billion annually, it says. Meanwhile, GE has already trimmed about 30,000 workers from its payroll this year.

But even if Immelt keeps the company strong in a sour economy, GE's share price may have a hard time keeping up. Before the attacks, it already was down one-third from its 52-week high because of a slumping economy and skittishness about a GE without Welch. Also, the Sept. 11 attacks showed up the nature of GE stock: Its 10 billion shares are liquid, widely held, and easy to dump. Many shareholders—including insurers paying out claims and mutual funds covering redemptions—did just that. **"UNPRONE TO GOOFING."** Even many of those who held on to their shares are not betting on a rapid rise anytime soon. "We're all trying to figure out what kind of risk premium GE should sell for," says Robert L. Meyer, pres-

ident of investment firm Ehrlich Meyer Associates Inc. "In this market, I don't think we'll see the kinds of multiples it used to get." Immelt can joke about that, saying that he still regards GE as a growth stock, "though you may need glasses to see that today." On Sept. 18, Immelt bought 25,000 GE shares at \$35.11 each. And Chief Financial Officer Keith S. Sherin says that GE's recently accelerated \$3 billion-a-year stock-buy-

back program made him empathize with Japan's efforts to prop up the yen.

Immelt's confidence, nevertheless pleased most investors, as did his openness and details about the problem ahead. As Immelt explains: "When there is a lot of uncertainty, it's important to bring people back to what's actually going on." That's already a break with the Welch regime where, some say, you were scared to blink in case you mis-

read a chart. This time, everyone got a bound copy of statistics and growth projections. One investor even mentioned it, prompting some applause. "I expected a vague 'rah-rah, GE,' touchy-feel kind of thing," says James Bitter, vice-president of asset management at Wilmington Trust Co. "I think Jeff today will be as unprone to goofing up as Welch was after 20 years."

Immelt already is putting his own twist on the top job. Gone is the intimidating bluster that characterized the Welch regime, though the top brass is still tightlipped about such sensitive issues as future layoffs. Immelt would estimate any layoffs attributable to the attacks, although he says the aircraft-engine unit will save \$500 million through layoffs and other cost cuts. In his Sept. 21 meeting, Immelt paced across the stage like a coach outlining moves before a big game, calling out to several audience members by name. Immelt spoke of the certainty ahead. But he also spoke of GE's ability to survive. "Probably the only good thing about the last few weeks," he says, "is that I don't get as nervous about Jack anymore."

There are surely tough times ahead for GE in the next years. Immelt seems to have convinced investors that GE can survive the recent event, although he admits he's shaken. "Not much has changed before Tuesday [Sept. 11]," he says. When it comes to GE, at least, he's not afraid of the future.

By Diane Brady
New York

HOW GE MAY GET HURT...

INSURANCE

GE provided some of the coverage for the World Trade Center and the jets lost in the attack. It expects \$600 million in pre-tax losses.

AIRCRAFT LEASING

Hard-hit airlines may miss payments or return planes. GE expects no hit to profits this year but \$120 million less in 2002.

AIRCRAFT ENGINES

Boeing pared expected deliveries through 2003 by 40%. That may cut \$100 million from operating profits now and \$200 million in 2002.

BROADCAST

NBC, like other networks, ran several days of ad-free coverage. That is expected to sap \$50 million from earnings this year.

...AND WHAT IT MUST DO

GE CAPITAL

Achieve strong growth in acquisition and financing activities to meet forecast.

AIRCRAFT ENGINES

Cut jobs and other costs to save \$500 million. Boost military sales.

GE's 170-MEGAWATT GAS TURBINE

POWER SYSTEMS

Hike earnings by more than 20%, already likely because of turbine and services backlog.

MEDICAL SYSTEMS

Expand service business and launch new products to meet 20% earnings-growth goal.



BusinessWeek on

For a Q&A with Jeff Immelt go to the Oct. 8 online edit: www.businessweek.com

A black and white photograph of a man's face reflected in a car's rearview mirror. The man is looking directly at the camera with a slight smile. The background shows a street scene with buildings and trees.

**Can I have eyes in the
back of my car?**

Video technology is moving from the birthday party to the rear bumper. Now, drivers can see what's really behind them. It's the kind of idea moving the auto industry forward. Advances in chip design make it possible. Whether it's enhancing graphic imaging or improving wireless and computing power, Synopsys IC design tools and services help engineers create the chips that lead to products that impact all of our lives. Or in the case of car design, no impact at all. See how Synopsys tools enable the products that change the world. www.synopsys.com

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THE INTERNET

BROADBAND AND MAIN

A determined Illinois town brings speedy Net access home



Cleathe Palmer's three-bedroom bungalow in Evanston, Ill., would spark envy in countless neighborhoods across the country. Not because it has more bedrooms than anybody else's, or the biggest yard. It's the wiring. The 35-year-old software developer has wired three computers together with a digital subscriber line (DSL) to the Internet that zips online at a sizzling 635 kilobits per second, some 11 times faster than most dial-up modems. "Yeah, it

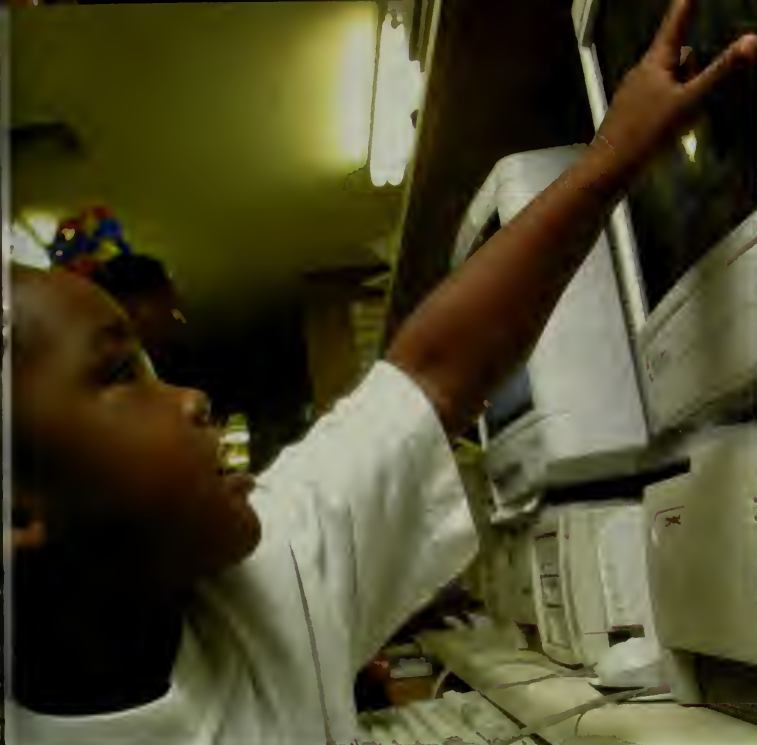
hums," Palmer says.

Spend one day with the Palmer family, and you see how that speed changes their lives. Nine-year-old Taurean downloads a feature-length film of the Japanese action cartoon *Dragon Ball Z* in less than an hour—something that would have taken all afternoon with a dial-up modem. Cleathe provides tech support for companies scattered around the world from his living-room recliner. And once a week, he watches *Monday Night Football* on his PC's 17-inch monitor—with extra features that few football fans can fathom. When the Green Bay Packers score against the Denver Broncos, an im-

age of Donald Driver's touchdown catch pops up, displaying his stats and history. There's even a chat room where Palmer can win points by predicting what the next play will be. "you have a high-speed connection," he boasts, "you get goods—all the bells and whistles."

Evanston is chock-full of households like Palmer's. In this leafy, picturesque town on the shores of Lake Michigan, north of Chicago, 15% of the 33,000 households have broadband connections to the Net, compared with 6% in the rest of the country. A tour through its main street of small businesses, nearby Northwestern University, and the surrounding homes offers a glimpse into the future of broadband in America. This is no Silicon Valley with technologies that geeks could love. What one finds in Evanston are the practical, simple, easy-to-use broadband applications that are likely to have appeal across the country.

What does the future look like? Families such as the Palmers watch videos, even TV shows, on their computers. Palmer's wife, Sheilece, zaps video e-mails to her brother in Orlando. Evanston teenagers, including Matthew Bell, play action games online in real time against competi-



1 Proud history 2 An Internet cafe 3 Checking lines for AT&T Broadband 4 The town supports a trailer with Net access to serve its poorest neighborhoods 5 Northwestern University is a major force in the push

ing in cities as far away as San Francisco and Stockholm. And business owners can run their operations more efficiently than before. Graphic designer Morris "Dino" Robinson could never afford the \$1,000 a month for the high-speed T-1 line that phone companies used to offer. But his one-person fit, Robinson Design, picked up a DSL broadband link in 1999 for a mere \$50 a month. Now, Robinson Design routinely caps logos and other art to customers in 2-gigabyte files, rather than the entire hard drive of many PCs. In the past, the firm had to send designs by courier or overnight mail to get customers' approval. "Now that I have broadband, I don't know how I could get along without it," says Robinson.

PARITIES. But Evanston also shows that the broadband future will be far short of Net nirvana. First off, it's not easy to get there. The town's leaders trudged up a long, tortuous path to make speedy Net links available. Worse, the market has become something of a duopoly after the telecom industry meltdown drove many upstarts into bankruptcy—a disconcerting development that is being repeated across the country. Without aggressive competition, the two companies that dominate the Evanston market, AT&T and the Ameritech division of SBC Communications Inc., hiked prices 25%, to \$50 a month, this year. What's more, service is irksome: Customers wait months for installation, and they often require more than one visit from a technician to work out all the kinks. Then, customers complain that their broadband links crash as often as twice a week. "It's not exactly simple plug-and-play," says Louis Bell, a lawyer who has DSL service in Evanston home.

More unsettling, the community's experience shows that the move to broadband threatens to widen the digital divide between rich and poor. While 43% of the U.S. population has some kind of Net access today, the figure is only 11% for households with incomes under \$15,000—like many on Evanston's west side. In Evanston's low-income, predominantly African-American neighborhoods, broadband penetration is nearly zero, while it's about 20% in wealthier neighborhoods. A \$50 monthly broadband bill is an impossible luxury for the poor. "Most people with computers get on anytime they want," says 15-year-old Annette

Taylor, who doesn't have Net access at home. "I can't."

Despite the frustrations, Evanston has much to teach the rest of the country. The town's experience shows that broadband can make a big difference in the way the Internet enriches people's lives at work and at home. But the transition to speedy Net connections doesn't happen easily or quickly. It takes a concerted, community-wide effort with cooperation from businesses and residents.

Evanston's journey began in 1999 when the townspeople created a nonprofit organization, e-Tropolis Evanston. The goal: getting broadband service to every citizen and every business. Northwestern played a key role by providing office space, technical advisers, and money for the cause. Businesses and residents also kicked in cash. Now, e-Tropolis encourages broadband carriers to enter the market and subsidizes service for certain Evanstonians, particularly low-income residents. For example, e-Tropolis persuaded AT&T Broadband to

extend its network so a local community center could have Net access—and e-Tropolis picks up the tab. "We're helping to accomplish their for-profit business objectives by reaching new areas of the community, and they're helping us get our community connected," says Charles R. Smith, executive director of e-Tropolis.

Why has Evanston become a window into the future of the Net? With about 75,000 residents in an eight-square-mile area, the town has a strong community spirit. Over the years, it has fought off at least three annexation attempts by Chicago. In the 1990s, town leaders were frustrated that Evanston was becoming a bedroom community for Chicago. They wanted to foster local businesses, especially tech companies.

Led by the likes of Ronald C. Kysiak, the executive director of a local economic development organization called Evanston Inventure, community leaders set out to build the communications infrastructure to attract tech companies. The idea was to turn Evanston into a thriving "Technopolis," re-

Special Report

TELECOM

plete with wired homes and virtual marketplaces. At first, he tried to raise private funds to extend Northwestern's fiber-optic network to the city's commercial buildings. That effort failed, but the task force Kysiak established evolved into e-Tropolis Evanston.

The ride toward a fully connected community has been as choppy as Lake Michigan on a windy fall day. After its formation in 1999, e-Tropolis started working with aggressive upstarts NorthPoint Communications and Phoenix Networks, which provide broadband with DSL technology. They were eager to get a toehold in the Chicago market and worked out a plan with e-Tropolis to sell discounted broadband in Evanston. But the sputtering U.S. economy and the subsequent tailspin of the telecom industry drove NorthPoint into bankruptcy earlier this year, and Phoenix into the arms of an acquirer. Both backed out of the plans to sell discounted service and cut off service to some customers.

BIG HELP. The miscue soured some people on broadband. When Phoenix ran into trouble, "all of a sudden our computer screens went blank," says Thomas Erd, owner of retailer The Spice House. "Customers were left stranded." He signed up with another broadband provider, but they shut down, too. "I'm thoroughly disgusted with these services. They set you up, and then they disappear," he says.

Despite the turmoil in the telecom industry, the town didn't give up. In the spring, e-Tropolis started working with bigger companies, including AT&T and Ameritech, that had the cash to keep rolling out service. The nonprofit group markets their services in advertisements on the e-Tropolis Web sites and lets residents take test runs at three community tech centers. The e-Tropolis effort, which has cost a total of \$500,000 so far, is paying off. AT&T has invested enough in its cable-television network in Evanston that it can offer broadband service to every house and many businesses in town, something it can't do throughout Chicago. Regional telephone operator Ameritech



BRIDGING THE GAP The town has pledged to provide more low-income Net access

Special Report

TELECOM



can offer DSL to about half of the homes and businesses in town. Sprint Corp., under Chicago General Manager Pam Parma, has even started offering broadband with a new technology called fixed wireless.

Evanston provides insight into why cable companies such as AT&T are beating out the phone companies in broadband battles across the country. In Evanston, Ameritech has roughly 15% of the broadband market while AT&T has about 85%. The biggest reason is availability. Consider the case of Michael Coxhead, a technology consultant. He tried to get DSL service from Ameritech for more than a year, calling every six weeks only to be told the service wasn't available yet. "It was always imminent," he says. In July, he called AT&T and got the speedy data service installed in two weeks.

That pattern is being repeated across the country: There are about 5 million cable-modem subscribers and fewer than

CONNECTING A COMMUNITY

The future of broadband can be glimpsed in the Chicago suburb of Evanston, where 15% of households have speedy Net connections, vs. 6% nationally. Here's how Evanston did it.

NO BROADBAND TO BE HAD Despite the Internet frenzy, speedy Net access wasn't available in much of Evanston in the late 1990s—with the exception of the town's Northwestern University.

RESPONSE Educators at Northwestern and local officials created a nonprofit group, e-Tropolis, to raise funds to extend Northwestern's network throughout the city, create a community Web portal, and market digital subscriber line service (DSL).

TELECOM TURMOIL E-Tropolis formed partnerships with upstarts Phoenix Networks and NorthPoint Communications to offer DSL. But Phoenix and NorthPoint ran into financial trouble during the telecom meltdown.

RESPONSE Evanston leaders switched from the upstarts to established heavyweights.

HIGH COST Since the turmoil, the market has become something of a duopoly between AT&T and Ameritech. With less competition, the giants have raised their prices 25%, to \$50 a month.

RESPONSE Customers will have to pay more. However, officials have partnered with the main library and schools to allow the public to use their Internet facilities.

DIGITAL DIVIDE In the west and southeast pockets of Evanston, where many of the city's low-income families live, broadband penetration is lowest. Many people there can't afford \$50 a month.

RESPONSE E-Tropolis has dedicated half of its resources to increasing access to broadband in poor neighborhoods. Alliances have been formed with churches and businesses to hold classes, donate PCs, and help fund an Internet community center.

3 million DSL subscribers, according to Goldman, Sachs Co. And that gap is unlikely to close, since cable companies are installing 6 out of 10 new broadband links in the U.S. Why aren't the phone companies more aggressive? Analysts think they aren't willing to make heavy investments in short term—and cut into earnings—even if it means long-term growth. "The most important reason for the slower pace we believe, is the desire of the telcos to control [profit] distribution from DSL," says analyst Frank J. Governali of Goldman Sachs. "We view this as a long-term problem for telecom. SBC says the only reason it has held up broadband is regulatory hurdles."

There are other factors at work. There's more strategic value for cable companies to upgrade their networks: Once a company invests in its cable network, it can sell phone service over as well as digital TV and broadband. The only additional service Ameritech can sell is broadband. Plus, it's cheaper for cable companies to provide broadband: It typically costs about \$300 per household to install broadband, compared with about \$500 for phone companies.

Whoever provides it, broadband is beginning to change the way people live. Just peek inside the Palmer house. Pal-



RESCUING DR. SHEMENSKI FROM THE SOUTH POLE TOOK A SPECIAL KIND OF COURAGE. IT ALSO TOOK A SPECIAL KIND OF PHONE.



DR. RONALD SHEMENSKI

*Rescued from the South Pole,
Wednesday, April 25, 2001.
Iridium kept the lines of
communication open
through the entire effort.*

The darkness goes on and on. Radios are mostly useless. And the air is so cold, it can turn a plane's hydraulic fluid to jelly. But if the doctor didn't get out before winter really closed in, his gall stones could have returned with fatal consequences. So when the third rescue attempt took

off in late April, the team counted on Iridium to keep their lines of communication open. It's the only system

capable of sending and receiving voice and data globally. Actually, Iridium helped the good doctor twice. Weeks earlier, he used it to contact the Denver specialist who helped diagnose his condition. To learn how Iridium can be there for you, simply call 1-866-947-4348 *toll-free*, or visit our website.



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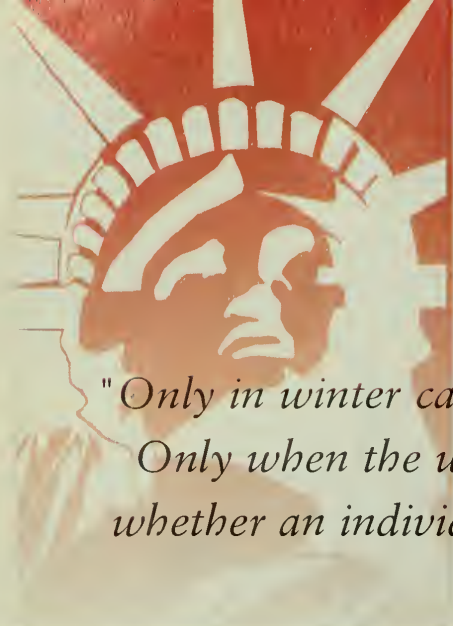
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*"Only in winter can you tell which trees are truly green.
Only when the winds of adversity blow can you tell
whether an individual or a country has steadfastness."*

John F. Kennedy

The unforgettable events of September 11 united New Yorkers, the country and the world in ways terrorists could never imagine. For as long as this nation stands, its citizens will proudly venerate those who lost their lives that dreadful Tuesday as well as those who worked so tirelessly to rescue others.

We at Standard & Poor's offer our condolences to the families, friends and clients affected by this national tragedy. Throughout the world we rededicate ourselves to serve the communities in which we operate and to further an understanding and an appreciation for the democratic institutions that came under attack.

**STANDARD
& POOR'S**



WIRELESS NET Pam arma is leading ort's broadband fort in Evanston

four children, ranging
ge from 6 to 13. Since
ordered DSL from
eritech in February,
, each family member
been less frustrated
more productive. Be-
one phone line han-
the house's voice ser-
plus Net connections
three PCs. Family
bers battled one an-
er for time online, not
ention the opportuni-
to make an uninter-
ted phone call. With
the phone is free for



while the computers share a connection to the Internet
is always on. The kids can play educational games on the
while dad logs into his company's network and mom
es a long-distance call. "It has really freed up the family
o a lot more at the same time," Palmer says.

IES, MESSAGES, GAMES. One clear result of getting broad-
l is that people spend more time online. Each broad-
l user spends an average of more than 21 hours a week
e, 35% more than the 16 hours Web surfers spend with
up modems, according to a joint study by consultant
insey & Co. and investment bank J.P. Morgan Chase &
Look no further than Matthew Bell, whose family got a
connection from Ameritech a year ago. After school, he
uds all afternoon hunkered over the computer in his up-
s bedroom and, after a quick break for dinner, goes
t back online. On one typical afternoon, he's on his com-
r, watching the movie *Alien* in one window, instant-mes-
g with friends in a second, and playing an online game in
rd. "Those types of things you can do a lot because of the
lwidth," he says.

igh-speed Internet access also is changing Evanston's

companies. At a recent meeting of local
business owners at the Blind Faith Cafe, a
vegetarian restaurant on Dempster Street,
all the chatter was about the Net and the
possibilities of e-commerce. The companies
started a Web site called shopevanston.com
in 1999. Now, with their own affordable
broadband links, businesses can link up to
the town's site and sell to customers
around the world. "When we started the
Web site two years ago, it was an Alice-in-
Wonderland thing. Now, it's more a fact of
life," says Paul Giddings, owner of art shop
Folkworks Gallery.

Not for everyone. In Evanston's poorest
neighborhoods, Net connections are rare
and broadband links are virtually nonexis-
tent. E-Tropolis' Smith has a mandate from
the city to use his group to try to close
this digital divide. The notion is that
Evanston will never become a New Econ-
omy center with thriving tech businesses if

its workforce isn't proficient on the Net.

The initiative is taking root out of the grandly named South-
east Evanston Recreation Education Center—in reality, a trailer
with several Internet links. Scores of African American
kids visit the center to check out the Net. Few of them have
PCs, and not
one has an In-
ternet connec-
tion at home. "I
found out all
the cool stuff you can do," says Olivia Lane, a 12-year-old
seventh grader. She loves the chat rooms, but she's also in-
trigued by news reports on MSN.

Still, in Evanston, local boosters aren't making grand pre-
dictions about broadband's possibilities. They know firsthand
how difficult the path to a speedy Internet can be. "It will
take 10 years to see if we're successful in this," says Kysiak,
the e-Tropolis visionary. In the meantime, the rest of the
country can catch a glimpse of the broadband ups and downs
headed their way.

By Roger O. Crockett in Evanston, Ill.



Special Report

TELECOM

A BROADBAND PRIMER

Broadband technologies differ in availability, speed, and price

CABLE MODEMS

data from the Net flows over
the same coaxial cable that
carries TV signals. Modems
split the Net data from TV data
and direct it to the PC. Cable is
10 to 20 times faster than a
kilobits-per-second modem.

COST \$40 to \$50 a month.

UPSIDE Speed to your PC
is lower than advertised,
and security is a big question
mark. PCs have to be located
near a TV cable in the home,
and a cable-repair person is
needed to hook the system up.

DSL

Phone companies turn their
copper wires into speedy Net con-
nections with digital subscriber
lines. DSL turns digital signals of
computers into sound waves and
zaps them through the phone
network. DSL is more than 10
times faster than a 56k modem.

COST About \$50 a month.

DOWNSIDE Speed to your PC can
be lower than advertised, and
from your PC is even slower.
Residents farther than 14,000
feet from a central phone office
probably can't get service.

SATELLITE

Satellites that beam TV signals
also transmit Net data. The
Net signals are collected on
dishes, split off from TV
signals, and routed to the PC.
Speeds are four to eight times
faster than a 56k modem.

COST \$60 to \$70 a month.

DOWNSIDE Most satellite
service is only one way, so
many customers need a
cumbersome setup to send
data back to the Net over
their regular phone line.
Two-way service is slower.

FIXED WIRELESS

The same airwaves used to
beam wireless phone calls can
be used to transmit Net data.
The signals are delivered from
wireless towers, collected on
dishes attached to the home,
and routed to the PC. Speeds
are 2 to 10 times faster than
a 56k modem.

COST \$30 to \$45 a month.

DOWNSIDE The service is
available in few places and
requires a clear line of sight
between the tower and a
customer's home.

The Unisys family around the world offers our sincerest condolences to all who lost loved ones in the enormous tragedies in New York City, Washington, D.C. and Somerset County, Pennsylvania. The events of September 11 are almost beyond comprehension. We witnessed the horrific as we moved through that fateful morning, and the heroic in all the days since.

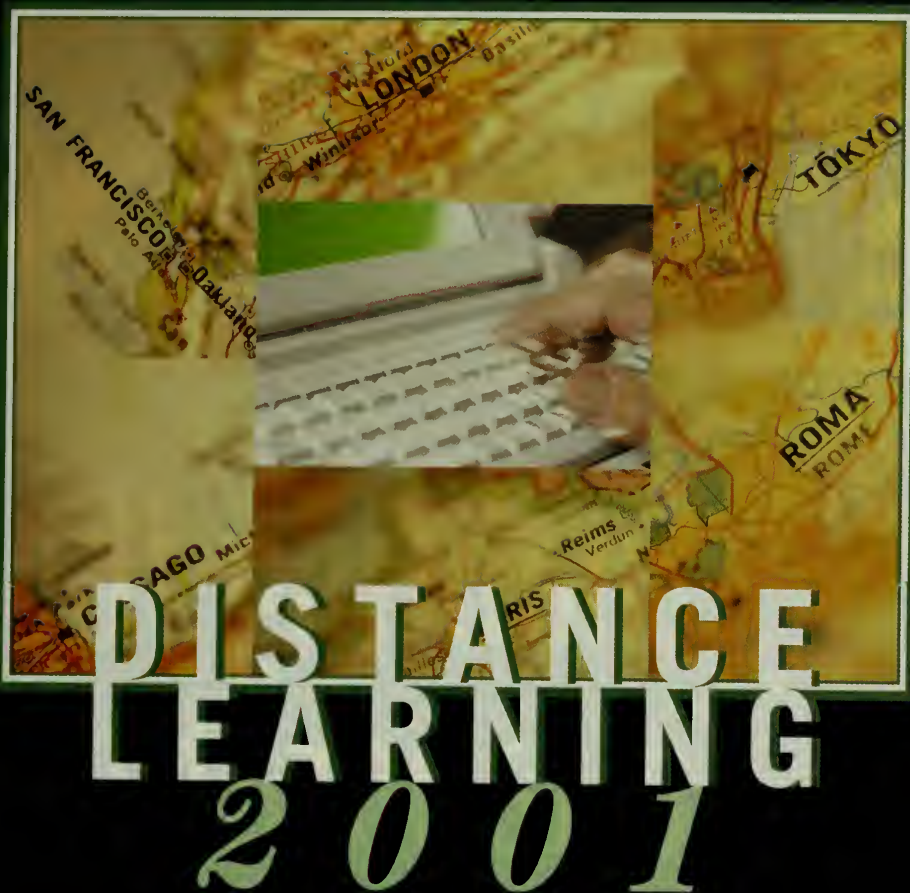
The horrific will always be etched in our memories. The heroic will unify us—perhaps as never before—in our resolve to rebuild and rebound from the failed attempt to challenge our freedom and democracy, as well as our will as a people.

We also thank and honor all those who have given, tirelessly and with unwavering hope, their skill and their spirit in the rescue efforts. You are an inspiration to every human soul.

These events will echo through the years ahead. But that echo will also carry the resolute voice of every person who will stand against the terror perpetrated on the innocent that morning. We will carry that echo in our hearts, forever.

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Eric K. Clemons
Professor of Information,
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Raymond C. Kurzweil
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Harry W. McKinney
President, Business
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Pradeep Sindhu,
Vice Chairman, CTO,
and Founder, Juniper
Networks, Inc.

ADDITIONAL CONFIRMED SPEAKERS

Michael Aguilar, President and COO,
Panasonic Company National

Daeje Chin, President and CEO, Digital
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BIOTECHNOLOGY

NEW, IMPROVED BLOOD?

Contenders emerge in the quest for an emergency substitute

Thanks to an unprecedented number of blood donations across America in the wake of the World Trade Center and Pentagon attacks, U.S. blood reserves are in excellent shape—for now. But a blood shortage is still a real possibility as the military prepares for battles on foreign shores. Because donated blood must be kept refrigerated and goes bad after 42 days, it may not be available where it's most needed. "Blood isn't something you can easily get to where the [military] action is," says Dr. Jeffrey D. Kerby, a laboratory director at Wilford Hall Medical Center at Lackland Air Force Base in Texas.

For the past two decades, the quest to develop a blood substitute has been pursued by tiny biotech startups and Big Pharma alike. Finally, potential winners are breaking out of the pack. On Aug. 28, Northfield Laboratories Inc. in Evanston, Ill., became the first company to file for Food & Drug Administration approval. Its product, PolyHeme, is derived from human blood. A

second company, Biopure Corp. in Cambridge, Mass., said it will file for approval of Hemopure, derived from cow's blood, by the end of the year. And Alliance Pharmaceutical Corp. in San Diego is in the late stages of testing a chemical blood substitute, Oxygent. These products, though different in makeup, have similar crucial attributes: They are compatible with any blood

DONATING IN ST. LOUIS: *The problem is getting fresh blood to the battlefield*

type and stay fresh for a year or more.

The technological effort that went into these products cannot be underestimated. Scientists have found it extremely hard to replicate the ability of red blood cells to ferry life-giving oxygen through the body. Some early blood substitutes worked in animals but proved toxic in humans. Even the blood substitutes being readied now are not meant to permanently replace the real thing. Artificial blood circulates only for a matter of hours, sustaining patients until they can replenish their own blood or get access to donated supplies.

TOUGH SELL. Still, artificial blood could save thousands of lives each year—provided it reaches the market. The three leading U.S. players are tiny, unprofitable, and need millions of dollars to ramp up production. Plus, the FDA is sure to be a tough critic. "This is not similar to any other product we've ever dealt with," says Dr. Abdu I. Alayash, who heads the FDA's program for blood research. "It's going to take a great deal of time and effort to understand

Of the three contenders, Northfield is in the lead and is so sure that PolyHeme will pass muster with the FDA that it has applied for fast-track approval, which would guarantee it a decision within six months. The company extracts still-potent hemoglobin from outdated blood and chemically transforms it into a purified solution compatible with all blood types. Northfield is seeking approval to stop oxygen loss in trauma patients until the patient can receive real blood. "It would eliminate the time required to test for compatibility and give the doctor more time to find the source of the bleeding," says President Steven A. Gould.

Despite those seeming advantages, Northfield has found it tough to

Vital Fluids: Three Promising Alternatives

PRODUCT

POLYHEME
Northfield Laboratories Inc.

HEMOPURE
Biopure Corp.

OXYGENT
Alliance Pharmaceutical

STATUS

Derived from human blood. Northfield applied for fast-track FDA approval on Aug. 28.

Derived from cow's blood. Human trials for orthopedic surgery completed in August.

Made of oxygen-carrying chemicals. In clinical trials. FDA filing won't come before 2003.

cruit trial participants—few patients in emergency situations care to volunteer. That leaves some experts wondering if the market will demand more data. "If you have an adverse reaction in 1 in 10,000 patients, that would be a concern," says Harvey G. Klachuk, chief of the National Institutes of Health's Transfusion Medicine

v. A small trial won't address that issue.

To reduce such hurdles, Northfield Biopure seeks approval for its Hemopure product only for use during orthopedic surgery, a much easier setting for recruiting volunteers. Hemopure is made by extracting hemoglobin from cow blood, then chemically modifying it in a 17-step process to make it compatible with humans. But Biopure must convince the FDA and the public that Hemopure won't transmit mad cow disease. The company uses only U.S.-bred cows and insists that its rigorous manufacturing method eliminates disease-causing agents. "We just need to get people to understand that," says CEO Carl W. Rausch.

If he fails, mad cow worries could carve a slice out of an already limited market. Orthopedic surgery represents just 15% of the potential \$12 billion market for blood substitutes, analysts say. But given that Hemopure can stay fresh for three years without refrigeration, it would be ideal for emergency situations. Biopure will keep researching other uses, but it's years away from having enough data to satisfy the FDA.

LOSSES. Alliance is in a similar bind. In January, the company halted a late-stage trial of Oxygent when some patients undergoing cardiac surgery suffered strokes. Oxygent is a milky mixture of chemicals designed to carry oxygen through the body. The company says that it was the method by which the concoction was injected and not the product itself that was faulty. It also believes that preexisting conditions common to heart patients, such as obesity and diabetes, may have made the study subjects more prone to strokes. To be sure, Alliance designed a new trial that uses only on elective, noncardiac surgery. "This needs to be tested in controlled, measurable settings, and it's hard to do in trauma," says Alliance CEO Duane J. Roth. The product won't be ready for FDA review until at least 2003.

All three companies are racing against time. Northfield has lost \$5.4 million so far this year, and Biopure \$4 million. Alliance, which is \$31 million in the hole, will receive an \$11 million infusion from marketing partner Inter Healthcare Corp. this year but still have to scrape up considerably more if it wants to survive beyond 2002. This sector has experienced spectacular failures, and that will make raising funds even more difficult," says CIBC World Markets analyst Steven B. Gerst. In other words, despite the hopes for blood substitutes, blood drives won't become a thing of the past.

By Arlene Weintraub in Los Angeles

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Developments to Watch

BY OTIS PORT

A LEAP IN DRUG RESEARCH FROM FROGS

SCIENTISTS FOR SOME 50 YEARS HAVE BEEN INTRIGUED BY the peculiar chemicals on the skins of tropical frogs—a sort of venom secreted to ward off predators. Only since the mid-1990s, though, have the latest high-precision analytical instruments begun to reveal some of the medical potential that could lie hidden in frog secretions.

In Ireland, at the University of Ulster's Coleraine campus, a research team led by biotechnology professor Chris Shaw has observed that peptides from the giant Mexican leaf frog can reduce the blood pressure of lab animals by 50%. And those from Australian tree frogs have spectacular antibiotic properties, killing bacteria by rupturing their cell walls. Shaw claims that bacteria cannot develop resistance to such peptides.

Given these promising results, the university has coughed up money for new equipment, including a chemical-synthesis facility that can produce sample peptides for screening by drug companies. Launching a drug startup at Ulster's incubator park is now under consideration. Shaw also wants to expand frog-collection efforts in Central and South America. Most of the fieldwork so far has been done in the rain forests of southern China, he says, adding: "We leave Monday next [Oct. 1] on another expedition to China."

FROG SKIN IS OOOZING WITH PROMISE



NITRIC OXIDE HELPS NETWORKS THINK LIKE YOUR BRAIN

SOFTWARE NETWORKS THAT mimic the brain's circuitry, known as neural nets, perform a wide range of jobs, from diagnosing diseases to uncovering correlations hidden in massive databases. While still primitive compared with a real brain, these networks may soon get much smarter, thanks to work by Philip Husbands and other artificial intelligence researchers at Britain's University of Sussex.

The team is building on recent discoveries about how

the brain actually works. It's not just a matter of electrical impulses exchanged among neurons. Messenger molecules of nitric oxide also play a key role in learning and memory. The nitric oxide doesn't necessarily travel along the brain's usual pathways, but diffuses through the brain like a gas, affecting remote neurons that have no direct physical link to the sending neuron. The Sussex team is building nets that emulate both brain mechanisms. One of them is a silicon brain for an android robot, which learned to walk and recognize objects faster than the team's other androids.

A BREATHALYZER IN YOUR DASHBOARD?

WHEN EDWARD S. KOLESAR heard in 1999 that Motorola planned to replace cell-phone batteries with a miniature fuel cell that would generate electricity from a chemical reaction fueled by alcohol, the Texas Christian University engineer got to wondering. Could he adapt a fuel cell to detect drunken drivers by generating an electrical signal when the alcohol vapors on a driver's breath exceeded a certain level? He succeeded—and his fuel-cell sensor not only detects when a driver has had too much to drink but also uses the electricity to send a radio alert to nearby cop cars.

The sensor can be hidden behind the dashboard. It samples the interior air continuously but generates electricity only when alcohol fumes are present—and broadcasts a warning only when they exceed a preset threshold. Kolesar says his handmade unit costs \$100, "so the price is going to go way down for mass-produced systems."

A van equipped with the gadget is being tested at the University of Texas at Arlington. One worry is that it might

be triggered by alcohol from after-shave or hairspray, but that hasn't happened so far. If all goes well, Kolesar figures the device should be ready for Detroit within a year. Eventually, he hopes, his brainchild will show up "in every car, every train, every bus, and every truck," and help end the highway slaughter by drunk drivers.

TOO FAR GONE TO WALK THE LINE?



INNOVATIONS

■ Ceramics generally snap like glass if bent—but not the concoction developed by researcher Kim Byung-Nam and his team at the National Institute for Materials Science in Tsukuba, Japan. They whipped up a mixture of zirconium, magnesium aluminate, and alumina that offers unusual ductility: It can bend and stretch. At high temperatures, it can be molded or stamped much like a metal, opening the door to replacing certain metal parts with lighter, stronger ceramics. The work is reported in the Sept. 20 *Nature* magazine.

■ Scientists discovered 11 years ago that silicon surfaces riddled with tiny holes can emit light. Holey silicon seemed set to make it big in light-emitting diodes (LEDs), displacing costly semiconductors such as gallium nitride. So why are porous-silicon LEDs still just a lab curiosity? Because silicon's optical properties soon fade away. Now, researchers at Purdue University, led by chemist Jullian M. Buriak, have found a way to "pickle" holey silicon—by zapping it with intense white light in the presence of gaseous compounds containing carbon and hydrogen. This creates a thin coating that preserves the optical properties.

■ Sometimes the brain produces too much of the chemical dopamine, a situation associated with Parkinson's disease. In the Sept. 28 issue of *Science*, researchers at Boston University Medical Center say common compounds used to treat depression may mitigate the problem—and slow down the disease.



SKECHERS
COLLECTION
FOOTWEAR

Supply Chain Collaboration and Visibility:

The Results Are Beginning to Show

Compiled by Lothair, Written by Norbridge

SUPPLY CHAIN CACOPHONY

Let's suppose you've taken some business associates to the theatre and everyone in your industry is there. Look to your left, and then to your right. If you see one of your suppliers on one side and one of your customers on the other, you're looking at your supply chain. As trading partners, you're exchanging material and products, services, information, and of course money. Sound simple? It's not. Working well? Don't count on it.

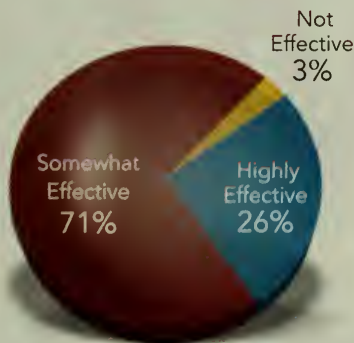
Multiply this analogy by all your customers and all your suppliers, and the whole sea of people in the theatre represents your supply and demand network. You can't possibly know what all of these companies are babbling about, and without realizing it, everyone is making trouble for everyone else. In a nutshell, most companies aren't sharing information and working together to the degree necessary for smooth execution of material sourcing, allocation, logistics, and customer order fulfillment.

Yes, a few outstanding companies have transformed their supply chains, often by leveraging the Internet, and the results are stunning. Dell and others have achieved internal efficiencies and customer service accolades that make other companies green with envy.

Most companies and industries, however, are way behind the leaders. In a recent survey of over 2,100 executives conducted by Cap Gemini Ernst & Young and *IndustryWeek*, 49% of the respondents reported that their companies neither have a formal value chain strategy ("value chain" refers to the combination of the supply and demand chain), nor are

they developing one. Among companies that have a strategy, most are not feeling very good about it (see pie chart below).

How Effective Are Value Chain Strategies?



Note: Represents 743 companies with formal value chain strategies.
Source: Cap Gemini Ernst & Young and *IndustryWeek*.

This is good news for those worried that the U.S. economy has hit the wall in terms of industrial productivity. When you're talking about the supply chain, most companies have huge opportunities for further performance and profit improvement.

THE FUNDAMENTALS – INCREASE VISIBILITY AND COLLABORATE

Most of the supply chain leaders would agree – a highly effective supply chain comes from comprehensive transformation of a broad set of business practices, with some help from information technology. To identify the right strategies and implement lasting changes, however,

you've got to get your arms around your problems and the problems of your supply chain partners. How? By increasing visibility throughout the supply chain and tackling the external processes with your partners.

Visibility = Turn the Lights On and Look at the Processes – How many units will your customers order over the next three months, and in what configuration of features? Have your suppliers shipped what you ordered last week and are the orders complete? If you don't know what's coming around the corner, your production and logistics people can only react to events as they happen, forcing plant disruptions, emergency transportation costs, and unhappy customers. If you can shine a bright light on the recent and current actions of your customers and suppliers, you can anticipate change and make better decisions.

"Visibility" information takes many forms, and is most useful when it can be consolidated into a handy measurement tool. One useful form, SupplySolution's i-Supply Service, has been adopted as part of Covisint's fulfillment application. On one page, the user can see the current inventory on hand and in transit, status of each item, customers' past and future usage rates, and the latest shipments received. Automatic alerts are sent via e-mail, pager, or fax when inventory falls below minimum or above maximum levels.

In the future, capturing supply chain "events" in real time will be much more automated. Using combinations of 2-D and 3-D bar codes, radio frequency tags, cell-based communications, and GPS,





Mark Leposky, TaylorMade's Vice President of Operations

What obstacles has TaylorMade faced in forecasting demand?

In the past, it has been a challenge to accurately predict which products we were going to sell. To guard against placing items on back order, we would build up our inventory. But there is a large capital investment required in terms of the inventory itself and distribution.

How did you respond to these challenges?

Last year, we surveyed the  market and selected i2 to help us more accurately forecast and manage customer demand. With i2 solutions in place, we will be able to transport raw materials with greater efficiency, double our rate of inventory turnover, reduce markdowns and write-offs, and increase velocity throughout the entire enterprise.

What kind of return do you expect?

We expect to generate \$50 million in value over the next three years. We are already seeing some intangible benefits, including more efficient communication with our partners. They love it because they now have much better visibility into the products coming their way.

"With i2, we expect to generate \$50 million in value over the next three years"

Why did you select i2? In our business, everything is high velocity. Information is coming from all different angles – from our customers, our suppliers, our salespeople. i2 provides proven systems for integrating all of this information. We need to have tools that will enable us to work faster, harder and with far greater agility. i2 gives us that competitive edge.

With nearly \$17 billion in audited, hard-dollar client value created to date, i2 is the value company. For information on i2 solutions for managing your dynamic value chain, visit www.i2.com or call 1-877-661-4890.



Powering the Bottom Line

HOW

accuracy
makes your game.



Companies like Qualcomm, Savi Technology, and WhereNet are filling out the "physical layer" of data collection needed to provide more frequent and more accurate information about materials and conveyances at rest and in motion.

Collaboration = Getting to Know You, Much Better – All trading partners have a transactional relationship, and they even share lots of information about their businesses. Collaboration goes much further to take the uncertainty out of future product supply/demand through joint planning and action.

By following a specified methodology – known as Collaborative Planning, Recasting and Replenishment (CPFR) – companies can dramatically improve supply chain effectiveness with new product and package design, demand planning, synchronized production scheduling, and logistics planning. According to the CGE&Y survey mentioned earlier, this practice is catching on: 25% of respondents indicated that CPFR has been implemented in their firms.

CPFR's popularity is spreading beyond company-to-company initiatives to include industry consortia as well.

In July, CPFR made a key breakthrough in the consumer packaged goods industry. Transora, a global B2B e-marketplace, introduced the CPFR-compliant Data Catalogue. Manufacturers will enter product-specific data (package size, nutritional information, pictures of the product) into the Catalogue, and that information will be searchable by retailers who have never had access to this amount of data before. The Catalogue is a first step for global standards of data exchange within the industry.

In August, CPFR was introduced to the top five hardware stores in North America (Ace Hardware, Do It Best Corp., Home Hardware Stores Ltd., Ronseal, and True Value Hardware) by E3 Corporation. These companies are using the CPFR approach to maintain and initiate collaborative relationships with vendors.

Supply chain visibility and collaboration capabilities are evolving rapidly,

and, not surprisingly, logistics experts often disagree on where this whole effort is headed.

ON THE RECORD WITH SUPPLY CHAIN'S LEADERS

Lothair and Norbridge hosted an Executive Round Table (see sidebar), during which 16 supply chain industry leaders engaged in a spirited, revealing discussion. What follows are their comments – some of the current best thinking on the subject.

Delegate introductions appear on last page of section.

DEFINING VISIBILITY AND COLLABORATION

REGAN, Tranzact Technologies: When you say "visibility" to me, what that basically means is the ability to see. When you're saying "turning the lights on," it's the ability to see throughout your entire operation. When you say the word "collaborate" from my vantage point, it's the ability to act. Now somewhere between the seeing and the acting is the thinking.

KIRKEGAARD, Vizional Technologies: Implementing visibility in the supply chain has actually turned the lights on to the whole process. The thing that is really compelling is that visibility reveals the areas that aren't working – that is the real impact it has had. And that, in turn, brings about collaboration.

POLIS, Dotcom Distribution: From the warehouse perspective, we can't ship it if we don't know what is coming in. When we have visibility, we can plan our outbound freight properly. Ultimately, it all leads to cost savings for our clients, and it increases the quality of Dotcom's services.

When Dotcom's first warehouse was opened last December, it attracted customers shipping both business-to-business as well as business-to-consumer.

Colgate Supports Worldwide Brands with Global Supply Chain

Company: Colgate-Palmolive Company manufactures and markets a wide variety of products globally, including toothpaste, soaps, laundry detergents, and pet foods.

Situation: Colgate operates in more than 200 countries and manages brands globally. Colgate began rolling out the SAP® core enterprise solution in 1995 to improve its operations. While this contributed to large gains in efficiency, Colgate wanted more visibility into customer demand and its own capacity so it could serve customers better.

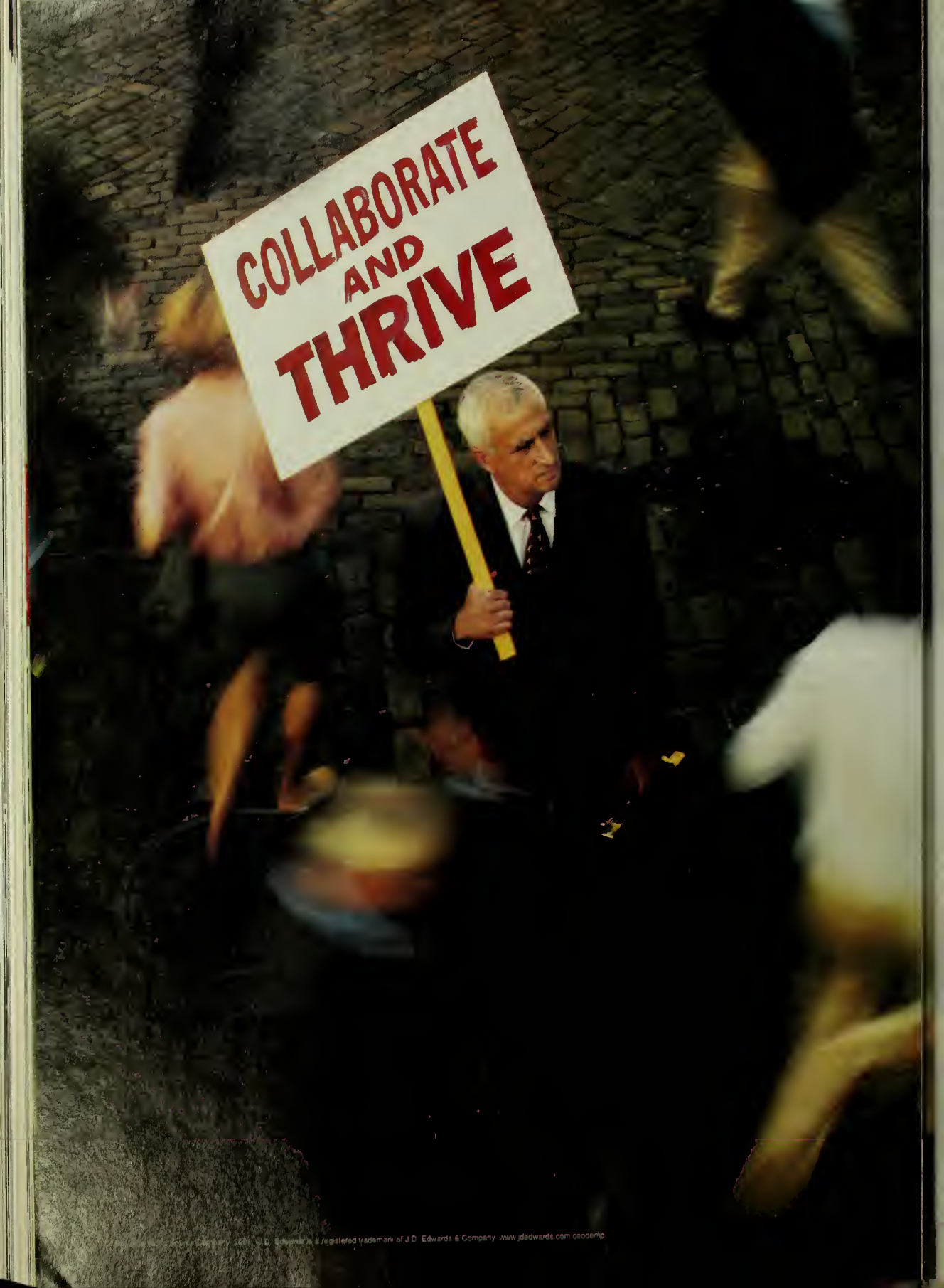
Goal: Colgate aimed to upgrade supply chain performance worldwide by replacing a regional sourcing model with a fully globalized supply chain built around vendor-managed inventory (VMI) with key accounts, cross-border sourcing, and collaborative planning with downstream subsidiaries. The business objective: improve service to retail and internal customers and reduce inventory and total delivered cost.

Process/Tools: Colgate selected mySAP™ Supply Chain Management (mySAP SCM) to provide instant, real-time access to information about orders, forecasts, production plans, and key performance indicators such as inventory levels and fulfillment rates.

Results: Colgate improved customer order fulfillment rates to 95 percent. It improved on-time and complete orders from 70 percent to 98 percent for VMI replenishment. It lowered inventory by 10 percent and reduced overall order cycle times. Colgate also increased compliance levels for intra-company replenishment.

mySAP SCM capabilities are critical to enhancing Colgate's global supply chain performance. mySAP SCM enables Colgate to gain visibility into global logistics data. It allows the company to optimize operations through the use of advanced mathematical planning functions. And it provides a platform for collaboration with Colgate customers and partners. By leveraging mySAP SCM, Colgate is progressing toward excellence in supply chain planning across worldwide operations.

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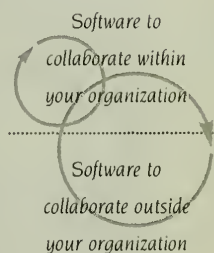
A man with white hair, wearing a dark suit, white shirt, and patterned tie, stands in the center of a crowded, cobblestone street. He is holding a white rectangular sign with a yellow pole. The sign has the words "COLLABORATE AND THRIVE" written in bold, red, sans-serif capital letters. The background is heavily blurred, showing the legs and feet of many people walking in various directions, suggesting a busy urban environment. The lighting is somewhat dim, and the overall tone is professional and focused.

**COLLABORATE
AND
THRIVE**

No CEO is an island. No company is, either.

In the Connected Economy, walls are down. And relationships rule the day. That means collaboration.

In other words, sharing information and processes inside and outside your enterprise. So that you can meet the changing business landscape head on. How do you get there?



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J D E D W A R D S

Ford Aims for "Available When Promised" with CGE&Y

Company: Ford Customer Service Division (FCSD), Ford Motor Company

Scale: More than 200,000 part numbers, 3100 suppliers, 5100 dealers, and 3500 employees

Situation: "Until now, the U.S. auto industry has pursued a service parts replenishment strategy with many large, one-size-fits-all local warehouses carrying high volumes of a broad selection of parts, which increases complexity," said Don Johnson, Global Director, FCSD Parts Supply and Logistics (PS&L). The new segmented network serves the same day/next day repair requirements, and those that are planned and/or more serious requiring second-day delivery.

Process: Ford is restructuring a parts delivery network around a customer-centric model. This design will be able to improve Order Response Time (ORT) by segmenting parts for timely repairs at the dealership. "This design strategy is unique because it utilizes decentralization and centralization of inventory simultaneously, to yield optimal service and cost savings," said Kent O'Hara, Ford Project Leader. The collaborative efforts of Ford, Cap Gemini Ernst & Young (CGE&Y), and others assisted Ford in developing segmentation methodologies. FCSD's new business model includes three warehouse categories:

- Nineteen High-Velocity Centers (HVCs) focus on the faster delivery of smaller, high-volume parts to dealers daily.
- One Low-Volume/Low-Cube Center (LV/LCC) holds small, slow-moving parts based on critical orders available within a 24-hour ORT.
- Three High-Cube Centers (HCCs) store large-size inventory items provided to dealers within a 24 to 48 hour ORT.

Results: Ford aims to achieve higher fill, faster ORTs and lower costs while delivering higher customer satisfaction from this network redesign. This should lead to:

Best-in-Class Service Satisfaction Examples:

- Best-in-Class "Available When Promised" Repair Completion at Dealerships
- Achieve a 95+% Repair Order Fill at Ford Dealerships
- Best-in-Class Dealer Fill Rate: 98+%

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- Web-based Information from Dealers to Suppliers
- Total Supply Chain Visibility
- Integrated Metrics and Information from Dealers to Suppliers

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One company, HerRoom.com, has quadrupled its sales by managing its business with Web-enabled real-time reports and visibility tools.

Of the 800,000 transactions they are managing right now, 80 percent are changes. We can instantly – in less than seven minutes – push this information out to the entire supply chain of this company, so everyone who needs to know is informed that there's been a change. There's a lot of power in that knowledge.

JENDROWSKI, NTE: We have been heavily involved in supply chain execution. There, collaboration really is a working community of networks, assets, people, resources, services...you name it. Yet, with the greatest collaboration, the larger the number of people involved, you are going to have errors; you are going to have exceptions. Without real-time defined visibility, and data with integrity, you suffer. They may be separate issues, but at the same time they have to go hand in hand. NTE delivers real-time collaboration tools with our leading customer members.

MARTHA, Mercer Management: Supply chain partners have increasingly behaved in a more collaborative manner. Over the past decade, collaboration has taken many forms – from enhanced communications to outsourcing of key activities such as distribution, manufacturing, and information systems. We like to think that these collaboration initiatives have compressed the supply chain and, in turn, reduced costs.

ALVERENGA, KPMG: It is incorrect to say that you need visibility to collaborate; sometimes it's actually inversely proportional, which means that the lesser the visibility you have, the more collaboration you need. For example, the reason you collaborate on the demand side is because you don't have visibility. Sometimes you collaborate because you can't get visibility.

HAVE WE ATTAINED ANY BENEFITS?

JOHNSON, SeeBeyond: The point is to reduce supply chain costs and inventory obsolescence! There are suppliers and manufacturers who are now leveraging technology to have real-time access to product demand. Many market leaders are now utilizing eBI technology to also collaborate between organizations real time. The ability to quickly modify demand forecasts, send "out-of-stock" alerts, and send replenishment orders and shipments will dramatically reduce supply chain costs.

MARTHA, Mercer Management: If all rosy, why have companies like Cisco had to write off more than \$2 billion of inventory? Or, why has Nike invested millions in supply chain software that has not delivered benefits? Part of the problem is that as companies begin to collaborate, they are really changing their business models. What they have not done, however, is change key operating practices that deal with the added complexity that is associated with collaboration.

Certain supply chains have been compressed, but the margin for error has also been dramatically reduced. To be successful, companies must enhance visibility so that it is much more accurate, and find ways not to exclude human intervention.

The opportunities provided by collaboration are great, but the need for enhanced visibility is even greater.

CICIO, Optum: We're at the very early stages of a new frontier. I'll give you a real example of a client, a well-publicized \$2 billion telecompany. Their customer ordered something, expected to get it, and didn't receive it. These are complex orders, with 150 line items and thousands of components, sourced out to dozens of suppliers, including their own internal manufacturing plants. The challenge was to establish the technology and the processes that could track each order.

"CGE&Y's unique strategies incorporated into our inventory segmentation allows us to optimize our entire network operations."

– Frederiek Toney
North American Director, PS&L
Ford Motor Company

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from the minute the supplier received an order, and we tracked that order through a complex supply chain.

BUTZOW, C.H. Robinson: The transportation aspect is not yet fully visible. That's because people try to make this a technology play, and it's really an execution play. Technology is an enhancement to the process, not the process itself. And if you look at where the holes are, we're still dealing with realities like the fact that there aren't many Internet-enabled stations at the back door of receiving – it's coming but it's not there today.

We have customers with whom we're actually seeing their real-time point-of-purchase data, and then replenishing those inventories. That gives us the ability to literally see what's happening on an hour-by-hour basis. Nevertheless, there are transportation departments at many companies that still don't know a product is shipping until it is 100 feet from the back dock. Yet, the order had been sitting there in that company for a period of three, four days. They still need visibility to plan an order cycle.

HEGAN, Tranzact Technologies: If you knew well in advance the orders that are going to be shipped, then you could collaborate with your carriers to ensure that the lowest-cost carrier in that particular lane was consistently used. However, what we see happening, and this is something that NTE addresses as well as C.H. Robinson, Ryder, and other 3PLs (third-party logistics companies), is the fact that it shows up at the dock on Monday, and it has to be shipped on Monday. Then the transportation department is forced to find a carrier that has the capacity to handle it, as opposed to the lowest-cost carrier in a particular lane.

ROBERS, Cap Gemini Ernst & Young: We just completed our annual Logistics & Transportation survey of major shippers.

One of the striking conclusions is the fact that many companies have just begun to climb the technology curve. For example, we asked shippers how they submit orders. Four percent submit by mail, 28 percent by fax, 30 percent by telephone, eight percent by sales rep, and only 11 percent by the Internet. There is still a tremendous opportunity in the area of B2B connections and real-time collaboration.

SHEPARD, Ryder: In my experience, larger Fortune 500 companies have more trouble embracing technology change, and being technology nimble. They have so much time, money, and resources tied up in legacy or outdated technology systems that it's tough for them to embrace new technology. Thus a general axiom: the bigger the Fortune 500 company, the worse the technology and the greater the technology challenge.

JUST WHAT HAVE WE LEARNED?

A L V E R E N G A , KPMG: For the answer to that question, I'll point you to Japan.

The downside to it, and this affects CPFR (collaboration, planning, forecasting, and replenishment), is that when companies collaborate too much, not only do you sometimes skirt legal issues, but you can get very comfortable with your partners. And you have to be very careful to assure that from the shareholder perspective the collaboration doesn't go a little bit too far.

BUTZOW, C.H. Robinson: I'm not an auto parts manufacturer, but I would have chosen not to participate in the ten percent automatic price reduction that one manufacturer recently imposed. But there are manufacturers that are so intertwined with their customers – what is their option? They can't just turn around and go over to another customer. And so I think collaboration can be a double-edged sword.

The Supply Chain Dance

Company: Coca-Cola FEMSA

Situation: Dance contestants in the Plaza de Armas begin to sway, spin, and twirl as the sun sets on Vera Cruz, Mexico. Residents and tourists line up to watch and cheer. And drink Coca-Cola. The popular soft drink is supplied to area restaurants by Coca-Cola FEMSA (KOF), a Mexican bottler and distributor, and one of many businesses around the world that recognize the need for powerful supply chain solutions.

Goal: Headquartered in Mexico City, KOF is the largest bottler of Coca-Cola products for Mexico and Argentina and the second-largest bottler and distributor of Coca-Cola products in Latin America. With eight production plants and 63 distribution centers, KOF needed a supply chain solution that could help decrease stock-outs, reduce inventory, minimize variability in operations, improve asset utilization, forecast accuracy, manage promotions, and enhance customer service. KOF implemented J.D. Edwards' Advanced Planning software to more effectively manage its manufacturing and distribution operations.

Process: In the company's Valley of Mexico plants, KOF has increased demand-planning accuracy up to 93 percent and reduced stock-outs to just 0.6 percent. The software has helped KOF redistribute production-planning operations due to a plant closing and is enabling the company to balance reduced inventory levels with shipping frequency. In production planning, J.D. Edwards Advanced Planning has helped KOF achieve 80 percent utilization of the production plan and reduced the number of necessary plant floor changes by 20 percent. In addition, J.D. Edwards' real-time Order Promising application factors plant floor changes into KOF's product availability dates. If a pallet of Coca-Cola is damaged, the order-processing system captures the information and updates the availability data so customer service reps promise only what KOF can deliver.

Result: Greater overall efficiency, and most importantly, happy Coca-Cola drinkers in Vera Cruz and throughout Latin America.

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GOLD, KPMG: And we have seen real live examples of companies that don't understand the cost metrics.

There are some companies that in the future might not want to collaborate on purpose. They may take the opposite approach of what we are talking about today.

There are reasons not to collaborate like we're seeing with the major retailers right now. They're not going to give data on forecasts. They're going the opposite of exactly what we're talking about, which is something that we've got to be ready for.

KIRKEGAARD, Vizional Technologies: Wal-Mart just shut down the "free sharing" of their retail POS information. While Wal-Mart probably has the most competitive exchange on the planet, and has used it for competitive advantage, a

potential downside could be that others realize just how valuable information is and thus it becomes more difficult to collaborate.

ROBERS, Cap Gemini Ernst & Young: Our point of view focuses on creating more adaptive supply chains based on extended enterprise visibility. Supply chain visibility allows for better control and execution. Integrating pricing actions on the demand side with the complex and ever-changing conditions of the supply chain can reduce costs, increase revenues, and make more efficient use of critical assets.

TECHNOLOGY SOLUTIONS OR PROCESS TRANSFORMATION?

BLACKWELL, Florida East Coast Industries: (Mr. Blackwell recently served

as Group Director - Transportation & Logistics of a major forest products company.) Technology is not the answer, but it certainly is an enabler. We had over 500 locations, and we didn't have visibility throughout the supply chain.

We used a variety of ERP (enterprise resource planning) solutions. In one case we spent tens of millions trying to put an ERP into effect and then abandoned it because our enterprise was so complex.

REGAN, Tranzact Technologies: I think we're doing a disservice to the readers if we don't point out that, often, companies tend to keep the systems rather than deal with the illness. I personally believe that a lot of CEOs find it is easier to write a check for a major systems implementation than to deal with the reality that their business model might be flawed.

All Aboard the Supply Chain Train

Climb aboard the Supply Chain Train. You've heard that advice, and 16 industry leaders took the step literally one day this past August. A special Executive Round Table was convened aboard the spectacular railcars of RailCruise America, headquartered at St. Louis Union Station, for a trip along some of the heartland's principal transportation arteries. The setting for the meeting and round table session was just right for a thorough exploration of the complex and fascinating topic, "Supply Chain Collaboration and Visibility."

The experience of the train trip was a pleasant way to look at underlying components of the supply chain from a new perspective.

The train is a supply chain manager's dream come true. It has been carefully planned from the three classic locomotives to the elegant observation car at the rear, all of which exceed every passenger's expectations. There are comfortable wood-paneled lounges, elegant dining cars, glass dome cars, meeting facilities, and an outside platform where passengers can watch the world glide by. It even has an entertainment car with a dance floor. The staff is up to the job, providing service that is courteous, friendly, and flawless.

"We provide an experience you just can't have anywhere else," says Kathy Louth, marketing director, RailCruise America. Indeed, the train is composed of classic American railcars, originally built in the 1950s for such famous American streamliners as the Union Pacific Railroad's City of Los Angeles. They were top drawer in their day, but what RailCruise America has done to them would leave even the original designers breathless.

From this plush perspective, our 16 Executive Round Table delegates, along with 30 invited guests, inspected the tracks of the Union Pacific while watching barges ply the majestic Mississippi River along our route. Bracketing the on-the-record session, all aboard found time to catch up on valuable industry acquaintances, as well as to make new ones.

Everyone agreed that the relaxed, professional ambiance of the RailCruise America train was the perfect setting for this unique mini-conference, capped with a memorable meal prepared as the train rolled through eastern Missouri. Best of all, the train is available year-round, from coast to coast, for future Executive Round Tables...as well as your corporate charter. You can learn more about this amazing train at www.railcruiseamerica.com or call 314-231-9500.



Elegant RailCruise America train (top left), provided by Kathy Louth, Marketing Director (top right), was the site of the Lothair/Norbridge Executive Round Table.

SHEPARD, *Ryder*: I'm a technology guy, and I often hear: "Give me ten pounds of technology and make it all go away." And we always say, no, you can't do that.

In a recent case, we spent almost a year looking at all of a customer's logistics business practices. And only then – when we had completed the gap analysis, agreed on what the process was (and is) and should be, and obtained the client sign off – did we bring in the IT people to start the functional design. It's a good example of a strong collaboration between our client, Applied Materials, our technology partners, SeeBeyond and Manhattan.

MATTHEWS, *Optum*: One of our customers was able to remove \$180 million in inventory costs in the first year. That's a significant number – and the kind of return you don't get from just seeing what's out there in your supply chain. It's a very interesting story. They didn't start with specific goals and aspirations for the project, but they knew they were hemorrhaging. They just knew they needed to make the supply chain more efficient. Achieving visibility was simply the first hurdle, because it revealed what wasn't working. The real ROI came from the cross-enterprise business processes that were applied and enforced by our software.

Looking at these huge savings with our client, we were able to attribute 25 percent of the savings to the product. But the bulk of that \$180 million in savings is a result of business process change they initiated.

MOREHOUSE, *A.T. Kearney*: Well, actually, I did have a word for this, and that is that every company's strategy is unique. Software doesn't solve the problem.

Also, I think we've completely missed a major point. We're sitting here like a bunch of operations people thinking we've got to respond to whatever the marketing folks decide they want to do to promote products, issue new products, or cut off products, or whatever it happens to be. And the fact of the matter is we shouldn't be sitting here just responding. We should be looking at this holistically, including the marketing and the new product development and the whole process. Instead of sitting here saying,

"How can I run new technology or do this a little better," it's important to first determine if we face a fundamentally flawed process.

GOLD, *KPMG*: Trading partners need to leverage technology to get connected first. Getting connected and determining how to communicate utilizing the right technology mediums and applications is a large task. The challenge today is more about the "how" to get connected rather than the "why." After trading partners figure out the "how," then they can begin to leverage the information they pass between them.

JOHNSON, *SeeBeyond*: First, like Ryder, you should focus on improving key processes that will drive value for you and your customers. Second, you must leverage proven technology to drive the

mySAP SCM capabilities are critical to enhancing Colgate's global supply chain performance.

desired value throughout the organization. Take the time to do it right.

ROBERS, *Cap Gemini Ernst & Young*: I hear a couple of common themes here. The first is that companies must use technology *intelligently*. The second is that companies must truly understand their business model. This is where Cap Gemini Ernst & Young is helping companies like Ford to implement their business strategy around service parts using a more customer-centric service model.

POLIS, *Dotcom Distribution*: What a CEO can do first of all is commit the company to embrace technology. But just as importantly he has to commit to change in his company. Unless a CEO commits to change in the company, any efforts will fail. It's that simple.

WHERE DO WE GO FROM HERE?

JENDROWSKI, *NTE*: We expect that the transportation industry will move to

the same type of model that has worked in the airline reservation industry. Today, virtually all airline bookings are done with a handful of companies who represent the airline carriers.

Similarly, NTE is one of the places shippers can go to secure and execute transportation services. We expect online availability of freight capacity to expand significantly over time. Private trading communities will be a major catalyst.

Also, NTE right now has many customers whose people are not trained to look at a browser window on the Internet. They want us to send them a fax that comes up behind them and then a little bell rings and says, I'm here.

KIRKEGAARD, *Vizional Technologies*: The most prolific measurement I've seen chipping away on this visibility supply chain problem, and it's been in the last ten years, is concurrency of information. Order visibility is the Rosetta Stone, the touchstone of concurrency. The breakthrough opportunity, to concurrently have many people acting on that problem has tremendous benefits not only for the planned order, but for the unplanned order.

ARNOLD, *Prologis*: As best practice move toward supply chain collaboration we foresee more customers including real estate in the strategic evaluations of their supply chain. This may well result in an optimization of distribution facilities through consolidations – in other words consolidating several smaller, local facilities into a larger regional distribution center. With our global presence and local expertise we are already working with several of our large customers to provide not only the supply chain evaluation but facilities as well.

CICIO, *Optum*: The new collaborative supply chain begins with connectivity and ends in superior profitability and customer service.

MOREHOUSE, *A.T. Kearney*: Because we look at process as a series of discrete steps, we can't see the whole picture and can't optimize. Therefore, we've got huge upside opportunity ahead of us. ■



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MODERATOR, DEAN WISE: Partner, Norbridge, Inc.: Management consultants focused on logistics and the transportation industry. (Assisted by Catherine LeGraw)



CARLOS ALVERENGA, Managing Director, KPMG Consulting: Responsible for the trading partner integration/cooperation practice and also for industrial, automotive, aerospace, and transportation supply chains.



GREG ARNOLD, First Vice President, Prologis: The largest owner and developer of distribution facilities, encompassing over 200 million square feet, with operations in North America, Europe, and Japan.



MICHAEL BLACKWELL, Vice President, Intermodal Sales and Marketing, Florida East Coast Industries: Previously, Michael was a senior logistics executive with a major forest products corporation.



BARRY BUTZOW, Senior Vice President, C.H. Robinson Worldwide: The largest third-party logistics provider in the country with 138 offices.



FRANK CICIO, Sr. Vice President General Manager – Tradestream, Optum: A technology company providing information services that manage cross-enterprise trade.



STEVE GOLD, Vice President, KPMG Consulting: Consulting focusing on systems integration, operations, and strategic positioning across the entire supply chain.



TOM JENDROWSKI, Vice President and Chief Operating Officer, NTE: An online marketplace for buyers and sellers of ground transportation throughout North America.



CHARLES JOHNSON, Global Manufacturing and Retail Industry Director, SeeBeyond: Offering a rapidly deployable and infinitely scalable infrastructure for seamless application integration, dynamic business-to-business connectivity, and agile business processes optimization.



HOST, BILL FAHRENWALD: Executive Director, Lothair, Inc.: Publishing and consulting in the logistics and supply chain industry for 20 years. Working with 3PLs, carriers, suppliers, software developers, and shipper across North America, providing market relations consulting and services.



JON KIRKEGAARD, Executive Vice President, Chief Marketing Officer, Vizional Technologies, Inc.: Providing private exchange technology for inventory, order, and logistics synchronization solutions, taking business value above and beyond just visibility and collaboration.



JOE MARTHA, Vice President, Mercer Management Consulting: Focusing on integrating strategy and operations while heading up the Supply Chain/Value Nets practice.



SCOTT MATTHEWS, Vice President Worldwide Sales, Optum: A technology company providing information services that manage cross-enterprise trade.



JAMES MOREHOUSE, Sr. Vice President, A.T. Kearney, Inc.: Responsible for casting a vision for what might be in the future, and then building the links to help companies get there.



JOHN POLIS, Executive Vice President, Dotcom Distribution: A third-party fulfillment company providing clients with high-speed, efficient services in both B2B and B2C environments.



MIKE REGAN, President, Tranzact Technologies: Providing systems support technology for shippers, plus a third-party logistics group that manages the transportation and logistics functions for small to mid-size companies.



PHIL ROBERS, Global Director, Supply Chain-B2B, Cap Gemini Ernst & Young: 4,000 professionals focused on supply chain practice and B2B technologies.

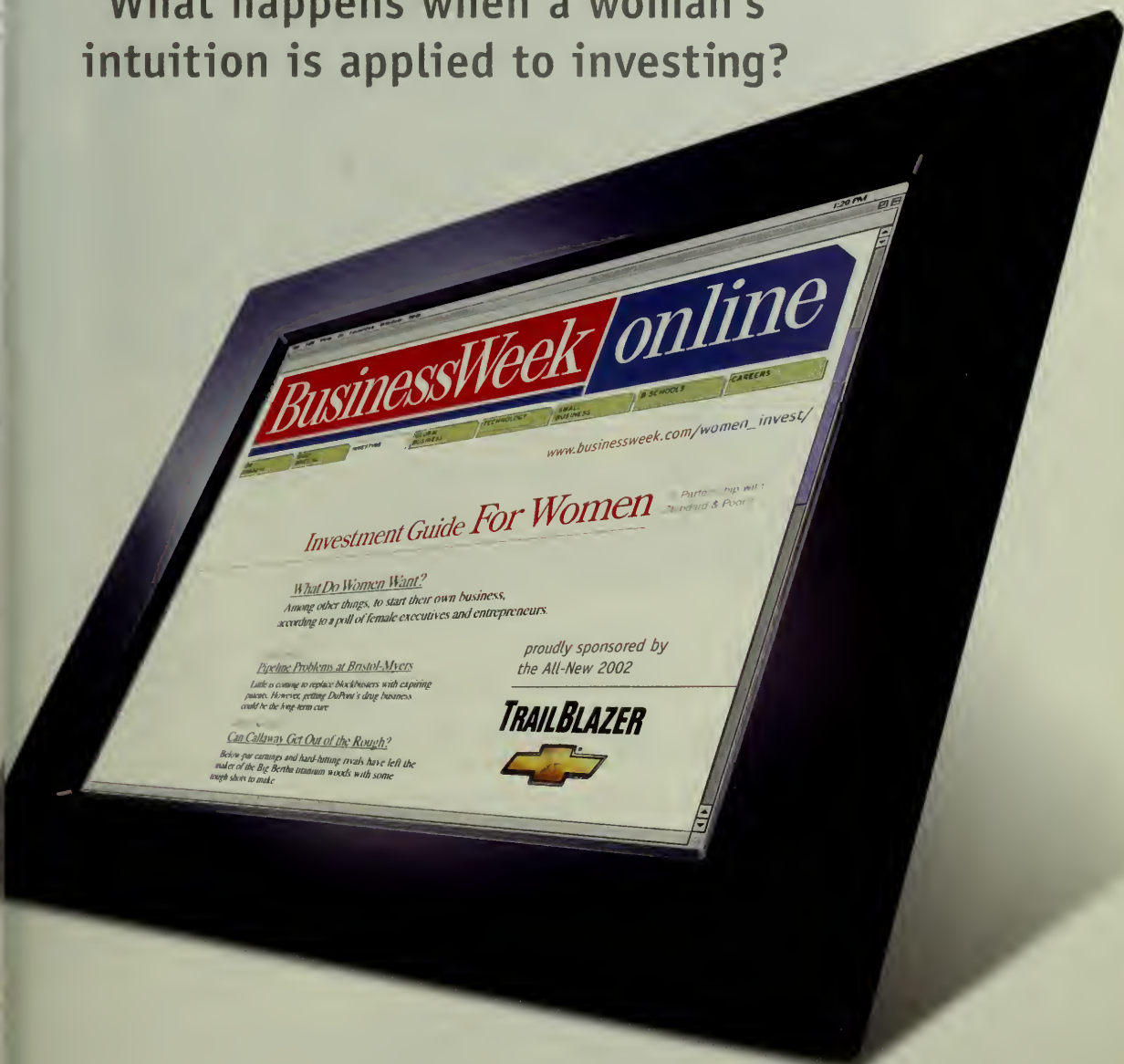


JOEL SHEPARD, Managing Director/General Manager, Global IT Solutions, Ryder: We are a \$5 billion, 33,000-person company. And I share that pleasure with my partners from Optum Tradestream and my good partner here from SeeBeyond.



Historic St. Louis (MO) Union Station was the origin of The Supply Chain Train, August 1, 2001. Delegates and guests pose aboard the rear observation car prior to departure.

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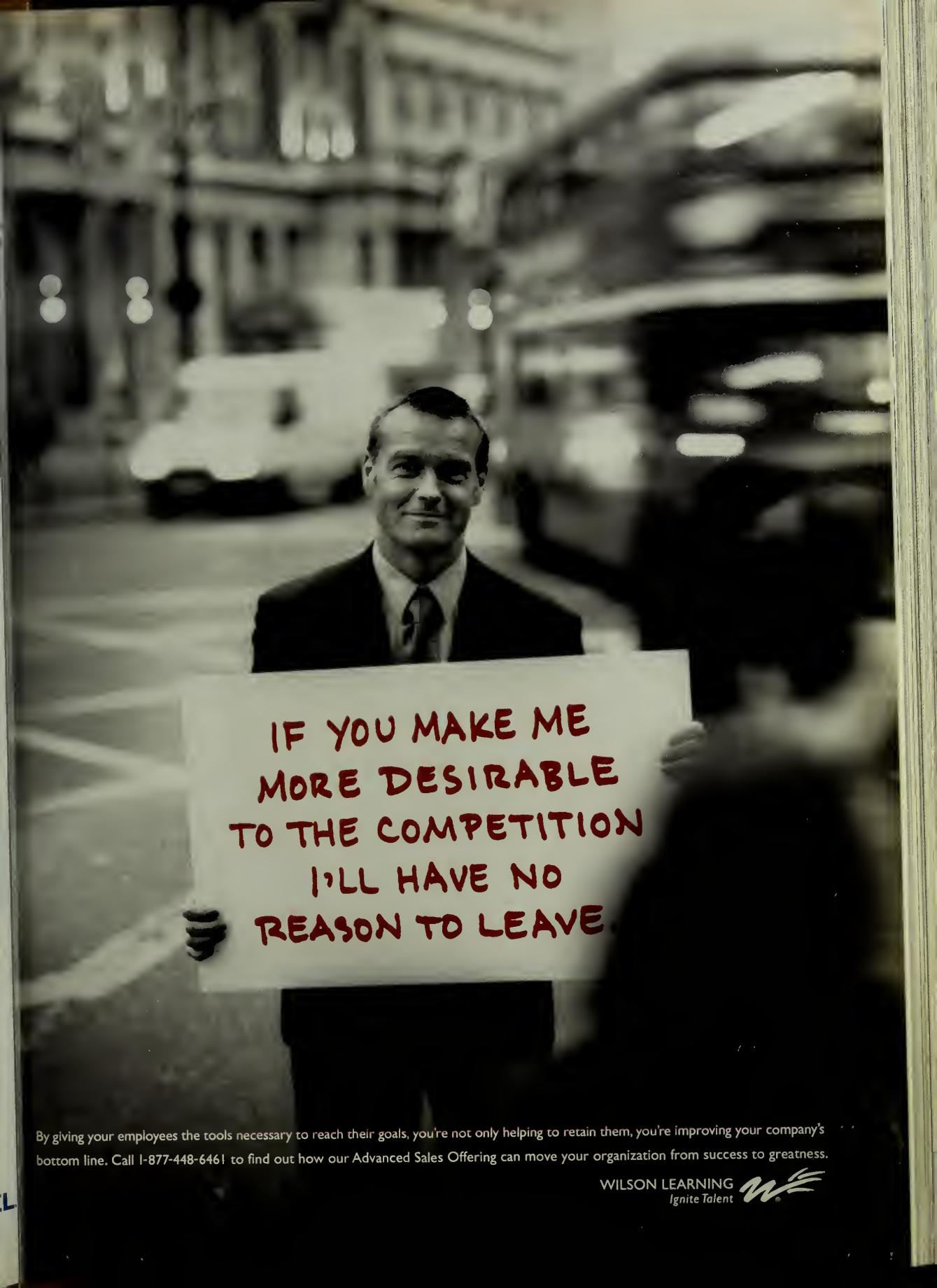
The tragic terrorist attacks in New York and Washington, D.C. have dramatically affected each and every one of us. In an effort to lend our assistance to the injured, bereaved, homeless, and displaced, we have created the Siebel America Fund.

The Siebel America Fund accepts contributions from Siebel employees. Funds collected from our employees to date exceed \$5 million. The proceeds of the Siebel America Fund have been contributed to the American Red Cross and to the Salvation Army in New York City and Washington, D.C. to provide direct assistance to individuals and families whose lives have been adversely impacted by these horrible events.

On behalf of Siebel Systems employees worldwide, our thoughts and prayers are with the families and loved ones of the individuals who lost their lives in this national tragedy, and with the courageous volunteers participating in the rescue and recovery operation.

Thomas M. Siebel
Chairman and CEO
Siebel Systems, Inc.

SIEBEL

A black and white photograph of a man in a dark suit, white shirt, and patterned tie. He is standing in the middle of a city street, looking directly at the camera with a slight smile. He is holding a large, white rectangular sign in front of his chest with both hands. The background is a blurred city street scene with cars and buildings, suggesting a busy urban environment.

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The image features a textured, yellowish-gold background. Overlaid on this are several concentric, organic, shell-like shapes. These shapes are composed of many thin, dark, parallel lines that follow the curve of the forms, creating a sense of depth and movement. The shapes are roughly oval and elongated, with some internal layering visible. The overall effect is reminiscent of a microscopic view of a cell or a cross-section of a natural growth pattern.

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We are grateful for the courageous efforts of the search and rescue teams.

We are confident that our collective strength and unbreakable spirit will help us heal.

We are committed to helping in any way we can.



Two Boulevard Cruisers That

Hardtop convertibles are back. The Lexus SC 430, with an automatically retractable roof, hit the market earlier this year. Ford followed in August with a Thunderbird convertible. Detroit correspondent David Welch drove both. Here are his reviews.

SC 430: Smooth Operator

Think Lexus, and the image is of comfortable but boring luxury cars. That's why the \$61,000 Lexus SC 430 convertible is attracting so much attention. On the outside, its bold, curvaceous form draws plenty of commentary, both flattering and otherwise. The interior design is so innovative that other auto makers are looking to mimic it. The ride and handling is comfortable and more spirited than your typical Lexus.

I have to give Toyota Motor credit for breaking the mold with this car even though I don't like everything about it. The rear is fat, and it slopes downward, giving the car a somewhat bulbous look. For a convertible, the SC 430 is noticeably tall from the ground to the top of the window sill. That's because Lexus needed a bigger body so its engineers could build enough space to store the hard top when it's pulled down.

STEALTH VINYL. The roof mechanism itself works effortlessly. Push one button and the top raises, folds, and disappears behind the backseat. But all that extra hardware makes the car heavy, leaves

little trunk space, and renders the rear seat useless except to hold a golf bag or two.

The inside design of this car is cool. When I climbed into my black test car, I was immediately impressed by the cognac-colored leather that surrounded me. It lined the doors, wrapped the steering wheel, covered much of the dashboard and the console, and made the plush seats sumptuous and inviting. In between the leather was brushed aluminum and real wood on the stereo controls. One nice touch: A wooden door revealed the stereo controls at the push of a button.

Then came a big letdown. Just to the right of the aluminum-encased audio controls, I noticed a small crack in the leather. I peered at it closely and then realized it wasn't leather but vinyl. Lexus obviously covered any surface that driver and passengers might touch with their hands in leather, but shaved a few pennies from the vehicle by stitching a thin vinyl into the dash. That's like sewing cheap plastic buttons onto an Armani suit.

On the road, the SC 430 is no BMW, but it took all that I could dish out in the way of abrupt right turns and swerves through traffic. The steering isn't as precise as it might be on a smaller, two-seat convertible. But the car handles quite well. Its powerful, 300-horsepower engine gives plenty of push and the automatic transmission shifts effortlessly. That makes the car a great boulevard cruiser. One big bonus: The SC 430 is sur-

Autos



p Their Lids

Lexus tackles the 'hardtop convertible' concept adroitly. As for Ford, nice try

ingly quiet for a convertible. The car shields passengers from the wind quite nicely, allowing for easy conversation even when the is down.

If you like the quirky styling, the car delivers cushiness of a Lexus but with more pizzazz.

Bird: Skin-Deep Beauty

One thing about the new Thunderbird is certain: it's the best T-Bird Ford ever made. But let's qualify that. The Thunderbird has historically been hugely overrated. The original 1955-57 Bird—a stylistic gem that spawned the new 's retro design—looked great but didn't drive well. Recent T-Birds, like the boxy version of the early 1980s and the bloated, mass-marketed T-Birds of the 1990s, have been laughable for so long that they're almost prestigious a marque.

On its own merits, the \$39,000 T-Bird is pretty good. Stylistically, it's a dreamboat. Like most of Ford's coupes, convertibles, and sports cars, the T-Bird is not a wedge of cheese on wheels. Instead of

sliding forward like a sports car, it tapers from the nose down to the tail for a laid-back look. When I toiled down Detroit's Woodward Avenue—the scene of an annual classic car cruise every year—I got a lot of looks. Everywhere I went, people stopped to gaze at my bright red test car. And it should keep its exclusivity. Ford plans to sell only 15,000 a year.

It's a nice ride, too. The car was designed for what Ford marketers call "relaxed sporti-

ness." It's not a nouveau muscle car for the 50-year-old divorced guy in a midlife crisis but more a stylish cruiser for aging boomers who yearn to head to the country for a Sunday drive. A long and heavy car, it tends to ride smoothly over potholes and bumps in the pavement. And its V-8 engine powers forth effortlessly and with authority. The steering is precise, but the car's weight keeps it from moving too nimbly. I took a few corners pretty hard and had to white-knuckle the steering wheel to keep it in line.

The T-Bird is at its best when the hard top is off, but that's not something you can do at the push of a button. In fact, the roof has to be removed manually, and the unit is so awkward and bulky that it requires two to do the job. When the hard

Ford Thunderbird

Price: \$35,495 for the basic convertible to \$38,995 for the premium model with the removable hard top.

Engine: 3.9-liter, 252-horsepower V-8



top is on, it squeaks and rattles. The annoying noises, along with some manufacturing snafus that Ford had when the company was trying to launch the car, make me wonder about the quality of the workmanship.

LINCOLNESQUE. Inside, the car falls well short of my expectations. When I first slid down into the cockpit, I got a feeling of déjà vu from the dashboard. It's almost the same plastic-laden instrument panel that Ford built into the Lincoln LS sedan. While that's not terrible, the interior is so dull it defies description. The only saving grace is a set of brushed-metal strips that run across the front of the dash and the doors. That's not the striking interior that I thought would come from the company that promised to "surprise and delight" customers.

For most T-Bird enthusiasts, the wait of nearly three years for the redesigned model has been enough. As long as history isn't too kind to Thunderbirds of the 1980s and 1990s, they'll think the newest one is worth every penny. Others may see the car as an overpriced beauty.

Lexus SC 430

Price: \$61,055 to \$61,895, depending on options

Engine: 4.3-liter, 300-horsepower V-8

PRIVATE JETS,
CELL PHONES,
AN INSURANCE
IPO

BusinessWeek Investor

A Jet You Can Call Your Own

Charter and part-owned planes are looking better

BY LEWIS BRAHAM

Even before the recent terrorist hijackings, John Jendricks was fed up with the commercial airlines. The vice-president of Milpitas (Calif.)-based Force10 Networks travels upwards of 100,000 miles a year visiting clients of his networking equipment business. To save precious time, last year he started booking business jets with charter brokers such as eBizJets and FlightTime. "I can make five stops across the country in just two days," he says. "On a commercial airline, that would take at least a week with delays and connecting flights."

Increasingly, busy executives are realizing that flying charter is worth the extra expense. Charter usage has grown 12% annually over the

past three years, double its historic average, according to charter research firm Boston Aviation Services. Security concerns will accelerate this growth. "Since the terrorist attack, eBizJets has taken an enormous number of calls from executives who now refuse to fly commercially," says Michael Jenkins, an eBizJets spokesperson. If you book the jet, you know the passengers.

BIG DRAW. But efficiency and comfort are still the primary reasons to fly charter. Charter jets go straight to your destination and leave on schedule—yours. The leather swivel seats, the catered meals, the DVD players and Internet hookups, the solitude, all are a big draw for harried travelers. "I make up every penny I pay extra for charter with better play on the golf course," says Douglas Tewell, a professional golfer and FlightTime flier. The time savings vs. scheduled flights will no doubt increase now that new security measures require earlier check-ins.

The Internet has augmented charter's efficiency—and made it easier for customers to find better deals. Web sites run by brokers such as FlightTime, Skyjet, and Air Charter Guide offer

online search and reservation tools similar to those available for airlines. Plug in your destination and departure time at Skyjet's search engine, and a list of available flights matching your criteria appears, including a detailed description of available jets: seating capacity, cruising speed, and flight altitude. You buy the ticket simply by clicking "Book."

The broker search engines are a big improvement over the past, when you had to call each charter company separately. But none offers a complete list of the flights available through more than 3,000 operators. To do a thorough comparison, you still need to visit several sites. In a recent search for round-trip passage for six people between Raleigh, N.C., and Des Moines, Skyjet's site listed a \$8,546 fare, FlightTime wanted \$13,122, and a commercial airline was charging \$8,154. Since charters bill per flight hour instead of per passenger, the savings become apparent when flying small groups of passengers (table).

Charter companies compete with the airlines that sell fractional ownership in airplanes, such as Executive Jet. With fractional ownership, flyers own an eighth or one-tenth interest in a business jet and pay for that proportional share of its use.

To fly on a six-seat jet such as a Cessna Citation Executive Jet charter

\$400,000 for a one-sixteenth share of the plane, \$5,224 in monthly management and maintenance fees, and \$1,318 per flight hour. Contracts run for five years, at the end of which you can sell your share to the fractional operator, usually for less than you originally paid. In the meantime, as long as you're flying for business purposes, you can deduct trip costs as well as the jet's depreciation in value each year.

Travel



CABIN IN THE SKY: A hassle-free ride is guaranteed



FREQUENT FLYER: Charters are worth "every penny" to Tewell

Aviation Consulting, requires its pilots to have at least 4,000 hours of in-the-air command experience, more than double the 1,500-hour standard mandated by the Federal Aviation Administration. EBizJets uses auditor Aviation Research Group/U.S., whose safety director, Peter Russo, developed the Defense Dept.'s aircraft audit program. SkyJet employs both of these firms.

Oddly enough, federal safety regulations are stricter for charter than fractionally owned jets because the FAA doesn't consider fractional jets to be "commercial aircraft." But top fractional operators employ their own internal auditing that can be quite stringent. "We train our pilots 22 days a year, twice the industry average," says Kevin Russell, senior vice-president of Executive Jet. Yet these extra precautions don't protect fractional owners from legal liability if something should go wrong. Because they are part owners, fractional flyers are liable for the safety of passengers even when they're not aboard. Those who hire a charter have no such liability.

Charter brokers are also working on the problem of "empty legs." In the past, whenever passengers were picked up in an out-of-the-way place, they would have to pay for the hours it took the plane to get there if no one else had booked that leg. Flight Time and eBizJets say they've eliminated empty-leg fees by using enough operators to always find an available plane nearby. Some experts argue, however, that brokers embed empty-leg costs in their fees.

Flying charter still costs more than traveling first-class on an airline. But the time saved and the convenience can make all the difference. "I got tired of commercial flights: the delays, the babies screaming, the tons of luggage coming down the aisle," says golfer Tewell. "First-class is not first-class anymore. It's just buying a bigger seat." Indeed, when you fly on a business jet, you're in a class by yourself. ■

Federal safety regulations are stricter for charter than for fractionally owned jets, which the FAA doesn't consider "commercial aircraft"

ty comparison, charter broker eBizJets of a plan that charges a fixed \$1,850 per flight for use of a small jet. The company gives a debit card worth \$100,000, then deducts cost of the flight time from the card. It will find any unused credits. FlightTime offers a similar package called Freedom Plan. It charges an annual membership fee that varies depending on the size of the plane and number of flight hours per year. For 25 hours on an eight-passenger jet, membership is \$35,556 a year plus \$50 per hour used. You must agree to sign up for at least 25 hours in this plan, but unused hours can be carried over to the next year. FlightTime's membership fee is nonrefundable.

SAFETY RECORDS. Industry experts say if you fly less than 200 flight hours a year, charter is usually a better deal than fractional ownership. The latter starts to make sense if you're racking up hundreds of hours of flight time because of the lower hourly cost and the tax benefits.

Safety is an especially important consideration in flying business jets. The safety records are a lot worse than commercial airlines because charter planes are flying into smaller airports, where it's harder to land," says Tom Aviation Services' Frederick Gevalt. The brokers do rigorous audits of their pilots and planes. FlightTime's auditor, Wyvern

Charter Gets More Competitive With Coach

ROUND-TRIP ROUTE	CHARTER COST*	FULL COACH FARE*	CHARTER PREMIUM (OR SAVINGS)		
			TWO PERSONS FLYING*	FOUR PERSONS FLYING*	SIX PERSONS FLYING*
ATLANTA-TO-NASHVILLE	\$2,750	\$901	\$948	(\$854)	(\$2,656)
CHICAGO-TO-CINCINNATI	3,178	1,129	920	(1,338)	(3,596)
DENVER-TO-ALBUQUERQUE	3,196	1,010	1,176	(844)	(2,864)
RALEIGH-TO-DES MOINES	8,546	1,359	5,828	3,110	392
NEW YORK-TO-PITTSBURGH	4,518	421	3,676	2,834	1,992
PHILADELPHIA-TO-BOSTON	4,847	663	3,521	2,195	869

*Prices as of Sept. 21, 2001, flying round-trip on Sept. 22, 2001

Data: Skyjet and Yahoo! Travel

Talking Your Family Through a Tough Time

Shared plans can help everyone stay in touch

BY
LARRY ARMSTRONG

You can also add extra numbers to your plan for \$10 to \$20 a month. Members don't need to live in the same place, and local calls between them may be free

Anyone watching the savage attacks on the World Trade Center and the Pentagon unfold was undoubtedly struck by the central role that cell phones played in the disaster. Once seen by many as a status symbol, and often as a nuisance, cell phones suddenly became a necessity. Wireless phones were the link to worried family and co-workers, beacons for search-and-rescue teams, and—tragically—the means to say a final good-bye.

Chances are that you already have a cell phone. Now you may want to consider equipping the rest of the family. It's also a good time to think through how to best use them in emergencies. For while the phones didn't work perfectly—many transmitters in New York City disappeared in the rubble, and wireless networks in many cities were rapidly saturated with calls—it's clear that they can be real lifesavers in less calamitous emergencies.

TAILORED. The best option is to sign up for or switch to a shared plan, usually called a family plan (table). Additional numbers can be added for \$10 to \$20 a month, less than the cheapest individual accounts, and everyone shares the same pool of monthly minutes, which get less costly the more you buy. Plan members don't have to live in the same household; you can equip your babysitter or aging parents who live nearby, and most carriers allow free local calls between plan members. Cingular Wireless and Verizon Wireless offer particularly broad choices that let you tailor a plan to your family's needs.

If you only want one or two new phones and a family plan isn't practical—your wireless service, say, is provided by your employer—stand-



alone plans from such carriers as Sprint PCS and AT&T Wireless go for as little as \$20 a month. With just 20 and 60 anytime minutes a month, respectively, they're clearly designed for emergency use only. Or, if you suspect that your teenager might have trouble curtailing social chats that eat up precious minutes, a prepaid service may be the way to go. Most carriers sell starter kits—with the first \$25 or \$50 worth of calls and the phone included—for \$100 or more.

As Sept. 11 made clear, it's better to carry your phone with you rather than sticking it in a drawer or glove compartment, the favorite hiding place of so-called emergency phones. Other tips:

- **Devise a family communications plan.** Since local phone lines are often down or congested during natural disasters, designate family members in other parts of the country as contacts to track the status and location of those affected. Program their numbers into everyone's phone.
- **Buy a car charger for your phones.** They cost about \$30 and will come in handy if there's an extended power outage.

- **Don't repeatedly hit the "redial" or "speed dial" button if your call doesn't go through.** Wait 10 seconds to let your wireless provider clear the line of an earlier attempt from its system.

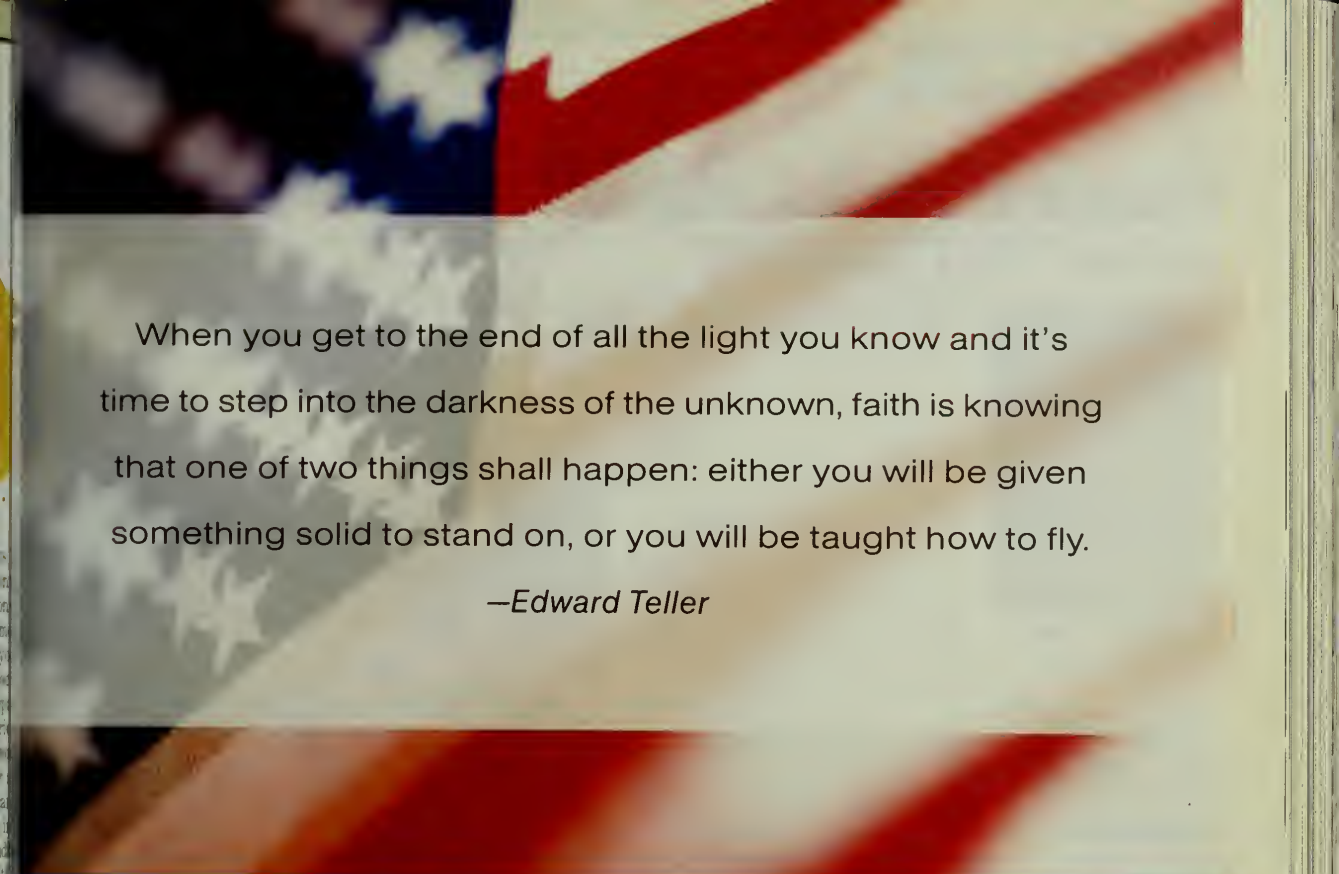
In the next several months, carriers will roll out technology that will make cell phones even more helpful in disasters. Soon, carriers will be able to pinpoint their phones to within a few yards—making it easier to locate the origi-

nal 911 calls. But because cell phones signal the network regularly if they're turned on, you can be found even if you're not able to dial 911. That would go a long way toward finding a tourist stranded by a blizzard or snowstorm.

Such emergencies never happen to you. If they should, you're better off if you're not carrying some gadget that will keep you in touch with your loved ones—and your potential rescuers.

What Cell-Phone Carriers Are Offering

CARRIER/PLAN	MONTHLY FEE FOR TWO LINES (EACH ADDITIONAL LINE)	ANYTIME MINUTES (EACH ADDITIONAL MINUTE OVER PLAN)	COMMENTS
AT&T WIRELESS SHARED ADVANTAGE	\$60 (\$20)	500 (35¢)	Voice mail optional; unlimited local calls between members
CINGULAR WIRELESS FAMILY TALK	\$67 (\$17)	500 (35¢)	Free long distance; available on any home plan from 150 (\$30) to 3,000 (\$200) minutes
SPRINT PCS FAMILY PLANS	\$70 (\$10)	450 (40¢)	Free long distance; also 1,000 minute plan (\$95 for two phones)
VERIZON WIRELESS FAMILY SHAREPLAN	\$65 (\$20)	450 (40¢)	Plans from 300 (\$35) to 1,300 (\$100) minutes; includes 250 local mobile-to-mobile minutes



When you get to the end of all the light you know and it's time to step into the darkness of the unknown, faith is knowing that one of two things shall happen: either you will be given something solid to stand on, or you will be taught how to fly.

—Edward Teller

From the thousands of employees of El Paso Corporation to the families and friends of the victims, we extend our deepest sympathy during this tragic time and add our voices to those already joined in sorrow. As a company and as individuals we stand ready to lend our funds, our skills, our labor, our time, and our resolve to assist in the rescue efforts, the rebuilding, and the reaffirmation of hope for the future.



CHICKS' PICKS COME HOME TO ROOST



BY TODDI GUTNER

hers@businessweek.com

The investment group failed to follow its own rules and had no strategy for risk and asset allocation

The Chicks have laid an egg. And I have egg on my face. On Oct. 6, 2000, I wrote in this column about Chicks Laying Nest Eggs—10 far-flung female friends and relatives who used cyberspace to organize what turned out to be a successful investment club. Their 10-stock portfolio handily beat the Standard & Poor's 500-stock index by 30 percentage points from October, 1998, through September, 2000. That led them to launch a Web site (www.chickslayingnesteggs.com) a year ago. The group's founder, Karin Housley of St. Paul, Minn., even wrote a book imparting the women's wisdom, *Chicks Laying Nest Eggs: How 10 Skirts Beat the Pants off Wall Street... And How You Can, Too*, published by Random House earlier this year. These Chicks, I wrote, "have proved to be no financial birdbrains."

Today I'm thinking that I am the birdbrain. "Everyone is a great investor with great returns during a bull market," notes Russell Kinnel, head equity analyst at Morningstar Inc. It's after the bull has had its run that investing prowess is determined. The Chicks' portfolio—which includes Yahoo!, Coca-Cola, and General Electric—has lost 35% from its inception nearly three years ago through Sept. 17, vs. a loss of 16% for the S&P 500.

CRAVING AOL. So what went wrong? For starters, the Chicks had 12 rules, gleaned from the teachings of such investment lions as Peter Lynch and Warren Buffett. But they ignored some of them. For instance, the Chicks' first and second rules—"Buy what you know" and "Be able to easily explain the company's industry and product"—were overlooked in the purchase of Sun Microsystems and EMC, down 78% and 70%, respectively, since their purchase. Housley admits that "maybe we should have understood a little better what they did."

Another rule—"Buy only when the stock price is lower than its 52-week average"—also was broken. "When we bought AOL, we were so hungry to get our hands on it, we didn't care what the price was," writes Housley in the book.

While they might have had a well-defined, if sometimes ignored, buy strategy, their sell strategy was

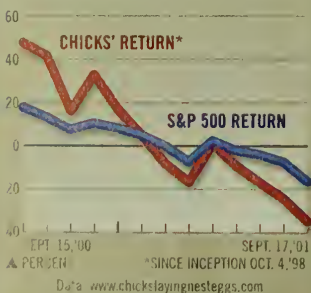
murky. When a stock fails to meet the Chicks' performance requirements for two quarters such as gross margins of 50% and net margin of 8%—the rules said the group should consider selling it. A year ago, that rule put the Chicks' 34 shares of Gap on the table. They voted, never came up with the six votes needed to sell. Margins continue to decline, and the stock is down 72% from when they bought it in June, 1999. **TECH-HEAVY.** Granted, even many investors are savvy buyers trip up on the sell side. "Sell is often the harder part to execute because people fall in love with their stocks," says Morningstar's Kinnel. "That's why professional



BULL RUN: The group expects its portfolio to rebound

Shrinking Nest Egg

Chicks Laying Nest Eggs launched its portfolio in September, 1998. In the first two years, it earned a return 2.5 times that of the Standard & Poor's 500. But by Sept. 17, 2001, its cumulative loss is more than twice that of the S&P.



investors have stringent sell disciplines." In their own defense, Housley says: "We've been using the club as a learning tool, not to make us rich." Housley takes comfort in the fact that professional portfolio managers, more experienced and financially astute than any of the Chicks, have been pummeled in today's markets. She believes that when the market comes back, the Chicks' portfolio will bounce back even stronger.

For my part, I managed to overlook the fact that risk and asset allocation were not mentioned at all, either in the Chicks' investment strategy or on their Web site. It turns out that a robust 56% of the Chicks' portfolio is invested in technology stocks; the S&P, meanwhile, has only 20% in tech companies. The women chose stocks with little regard to portfolio diversification.

Humbled by my experience, I now recall an old Wall Street bromide: "Don't confuse bull with a bull market." Had I remembered that, saying a year ago, I might have thought differently of the Chicks.

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ONE OF THE BEST WAYS TO PREDICT A PRE-OWNED VEHICLE'S FUTURE IS TO TAKE A LOOK AT ITS PAST.



Main Street Ford, Inc.

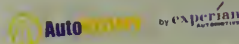
Vehicle Details:

VIN: 1FALP59U1YA941524
Make: Ford
Model: Taurus SE
Year: 2000

Body: 4 Door Sedan 4-6 Passengers
Engine: 6- 182-EFI-3.0L
Assembled: United States

Auto History Events:

Last Reporting State/Province:	MI
Last Title Number:	901M1198154
Duplicate Title:	No
Last Date:	04/20/2000
Last Odometer:	10
Rollback:	No
Salvage:	No
Exceeds Mechanical Limits:	No
Failed Emission:	No
Not Actual Miles:	No
Damage:	No
Major Damage Incident:	No
Insurance Theft Claim:	No
Water Damage:	No
Lemon:	No
Odometer Independent Source:	No
Other Odometer Brand:	No



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AN INSURANCE IPO THAT LOOKS HEALTHY



BY ROBERT BARKER
rb@businessweek.com

Principal Financial, while not a stellar performer, is solidly profitable, compares well with its peers—and is unlikely to face many claims from the attacks

Along with most of the nation's major life insurers, Principal Financial Group reacted swiftly to the terrorist attacks on America. It set up a toll-free hotline. It advertised its readiness to pay claims and extend deadlines for premiums. And it pledged up to \$2 million in relief donations. Yet unlike most insurers, before the terrorists struck, "The Principal" had been busily putting final touches on an initial public offering, tentatively set for October.

Since Sept. 11, Principal and its lead underwriter, Goldman Sachs, have been focusing on more urgent issues, including whether Principal's total claim payments will be sizable. (The early estimate is no.) But unlike Continental Airlines, which shelved an imminent IPO of its regional jet service, Continental Express, Principal still hopes to be able to go forward with its IPO soon, a spokesman told me, if the bear market allows.

SMALL-BIZ FOCUS. I suspect it will go ahead, for two reasons: First, the \$2 billion deal is supposed to complete a corporate reorganization that is turning a 122-year-old mutual company owned by policyholders into a public company owned by stockholders. Principal has been at this tedious task since 1998 and would hate to quit now. Second, despite recent declines in share prices of its publicly traded rivals, the price Principal is asking for its shares still looks reasonable (table).

Based in Des Moines, Principal over the years has cultivated a down-home image, catering to the needs of small-business clients. But its offices and 13 million customers now stretch to Latin America, Europe, Asia, and Down Under, where Principal in 1999 paid Deutsche Bank \$1.4 billion for a money-management operation it picked up in its own purchase of Bankers Trust. Managing other people's money, \$117 billion in institutional accounts, 401(k) plans, plus a family of mutual funds, now ranks as Principal's biggest business. But the company also makes mortgage loans, runs an online bank, and still sells its traditional life and health policies.

How is Principal set for the future? Ahead of its IPO, its executives are staying quiet. But you look at the company's financial statements you will find a sound, if sluggish, operation. Total revenues since 1996 have run flat, reaching \$8 billion in the 12 months ended on June 30. Earnings have bounced around a little more, in the past 12 months came in at \$599 million, well off their 1999 peak of \$742 million. With borrowings of \$2.1 billion, including the \$1 billion it took to finance the Deutsche Bank deal, total debt comes to nearly a third of equity. **MIDDLE OF THE PACK.** Against so many IPOs to float in on the whisper of black ink two years out, Principal's long history and solidly profitable record are a rare sight. But next to John Hancock

Financial, which went public early last year, performance and financial position hardly inspire awe. Hancock, with the debt that comes to 14% of equity, is much less leveraged. It is far more profitable. Less in revenues (\$7.5 billion) in the year ended June 30, Hancock delivered sharply higher profits (\$764 million). If you can look at it any way: With half as many employees, Hancock manages to be much more efficient. It netted nearly \$90,000 in profit per employee; Principal's average employee accounts

VITAL SIGNS

COMPANY/ SYMBOL	JOHN HANCOCK JHF	METLIFE MET	PRINCIPAL PFG
REVENUES* MILLIONS	\$7,506	32,113	8,840
NET INCOME*	\$ 764	1,439	599
TOTAL DEBT AS % OF EQUITY*	14%	22	32
MARKET VALUE** MILLIONS	\$10,961	19,353	7,020
PRICE-EARNINGS RATIO	14.3	13.4	11.7
PRICE-BOOK VALUE RATIO	1.8	1.2	1.1

*For 12 months ending on June 30; total debt as of June 30

**As of Sept. 20. Principal's market value as indicated by estimated IPO price of \$19.50 a share

Data: Company reports, BusinessWeek

for not quite \$34,000 in profit.

If that sounds terrible, it could be worse. Much bigger MetLife, which went public shortly after Hancock, netted less than \$31,000 per employee in the past 12 months. And giant mutual fund, which still plans to go public by year's end, saw each of its employees account for net profit of \$6,200. The point of all this pencil work? It is simply to suggest that Principal, while not the best performer among mutual insurers that have gone public, also is far from the pits.

So, as with most IPOs, the question comes down to price. At last estimate—before the attacks of Sept. 11—Principal figured its IPO would come to market near \$19.50 a share. That's a market capitalization of \$7 billion, or 1.1 times book value. Hancock now commands 1.8 times book, and MetLife, 1.2 times. Given that, Principal still stands a good chance of going public despite the times we live in now. And if the times force Principal to cut the price of its shares from a reasonable \$19.50 to something unsavoryly cheaper, you might want to take a look

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WHAT WILL NOT
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Morgan[^]Stanley

"My humanity is bound up in yours,
for we can only be human together."

Archbishop Desmond Tutu

Our Intel family of 88,000 joins the world in expressing our condolences
to all those affected by the tragedies of September 11.



INSURANCE: WHO WINS



GENE G. MARCIAL

Insurance brokers, sure—as rates coverage soar. Crossmann's little ses should either the storm. Singing Machine a top note with younger crowd

Since Sept. 11, insurance brokers have parted ways with insurance companies: Brokers stocks have soared, while insurers have plummeted. The reason: Brokers don't face underwriting risks—and won't be exposed to large claims. In fact, brokers stand to benefit: A surge is expected in demand for coverage. So the analysts have raised their earnings estimates on brokers by 30% to 50%, notes Steven Kroll, managing director at investment bank Monness, Crespi, Hardt. He says insurance rates are expected to double and insurance coverage to swell

KROLL'S TOP STOCK PICKS

STOCK	PRICE 9/26/01	EARNINGS ESTIMATES			12-MONTH TARGET
		2001	2002	2003	
MARSH	92	\$4.49	\$5.50	\$6.50	200
HILB	43	1.82	2.30	3.00	90
GALLAGHER	33	1.60	2.10	3.00	80
BROWN	49	1.56	2.50	3.00	90
WILLIS	22	0.75	1.50	2.50	75

DATA: MONNESS, CRESPI, HAROT; BLOOMBERG FINANCIAL MARKETS; BW

by 30% in the next few years. The brokers get an estimated 3% to 5% commission on policies they place. Thus, they gain not only from a jump in rates but also from the rise in coverage.

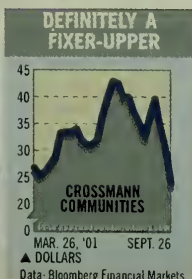
So Kroll is bullish on Marsh & McLennan (MMC), which owns the world's top insurance broker; Hilb, Rogal & Hamilton (HRH), the seventh-largest U.S. broker; Arthur J. Gallagher (AJG), with 200 offices in the U.S. and eight foreign nations; Brown & Brown (BRO), a diversified broker selling primarily property and casualty; and Willis Group Holdings (WSH), serving the construction, aerospace, and energy industries.

Analyst Joanne Smith of Salomon Smith Barney has raised her rating on Marsh & McLennan from "buy" to "strong buy." Says Smith: "We are comfortable that MMC could produce better-than-expected earnings and revenue growth due to a probable hardening in primary and reinsurance property and casualty premium rates."

CROSSMANN JUST KEEPS ON BUILDING



NAVELLIER:
High on houses



Although Louis Navellier expects a lot more volatility due to the attacks, he thinks it's the time to buy. If history is any guide, says Navellier, whose Navellier & Associates steers \$6 billion, investors "will miss a great chance" if they ignore the values that abound after a catastrophic event or a horrendous market crash.

A sector that he thinks offers attractive values is homebuilding,

and he is bullish on little-known Crossmann Communities (CROS): It builds low-cost, entry-level houses in the Midwest and Southeast.

The stock, at 23 a share, is down from its 52-week high of 45 hit in early July. Navellier says it's very undervalued, considering Crossmann's strong earnings growth and low price-earnings ratio. Based on the consensus Thomson Financial/First Call earnings estimate of \$4.93 a share for 2001, the stock is trading at a depressed p-e of 4.8. And based on 2002's estimated earnings of \$5.62, the stock trades at a 4.2 multiple. Last year, Crossmann earned \$3.28, fully diluted.

The key in this market is earnings, says Navellier, who expects many companies will continue to post poor results. Crossmann is a pillar in that sense, "and I'm not worried at all," he says. The Northeast is feeling numb right now in terms of homebuilding because of the attack, he says. But in the regions where it operates, Crossmann is standing strong, he says.

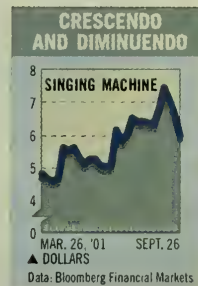
STAYING AT HOME —WITH KARAOKE?

With families avoiding vacations and travel because of terrorism, some investors think tiny Singing Machine (SMD) is a timely play. The company makes home karaoke machines. Its newest product, Singing Machine MTV STVG-700, is the first stand-alone karaoke machine that has a built-in 7-in. TV screen—where the lyrics can scroll in sync with the music. A line of CDs, with graphics featuring MTV's core music, complements the machine.

John Klecha, Singing Machine president, expects the new device, designed in partnership with MTV, to attract the younger crowd. He says the new product is a "hot item" at such retailers as Best Buy, Wal-Mart Stores, and J.C. Penney.

Singing Machine, which hit 7.56 in August—soon after the new machine's launch—is down to 6 in the wake of the attacks. But one New York money manager who has been accumulating shares expects the stock to top its old high even before sales ramp up in anticipation of Christmas. He thinks the stock deserves a 15 p-e, or 22 a share, in 12 to 18 months.

In the fiscal year ended Mar. 31, 2001, Singing Machine posted earnings of \$4.2 million, or 84¢ a share, on overall sales of \$34.3 million. In 2002, this pro expects the company to earn \$6.6 million, or \$1.50 a share, on \$75 million in sales. Klecha says the estimated figures "are definitely doable."

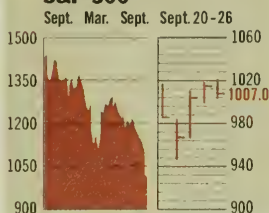


BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:10 p.m. EST on CNN's *The Money Gang*.

Stocks

S&P 500



COMMENTARY

The Dow Jones Industrial average, the S&P 500, and the Nasdaq Composite sank to their 52-week lows on Sept. 21 before recovering somewhat on Sept. 24. For the week, the Dow, S&P 500, and Nasdaq fell 2.2%, 0.9%, and 4.2%, respectively. There's a back-to-the-future quality to equity markets, however: U.S. exchanges have not seen these levels since 1998.

Data: Bloomberg Financial Markets
Bridge Information Systems, Inc.

U.S. MARKETS

	Sept. 26	Week	Year to date	Last 12 months
S&P 500	1007.0	-0.9	-23.7	-29.4
Dow Jones Industrials	8567.4	-2.2	-20.6	-19.4
Nasdaq Composite	1464.0	-4.2	-40.7	-60.3
S&P MidCap 400	414.3	-3.4	-19.8	-21.4
S&P SmallCap 600	186.4	-2.6	-15.1	-12.5
Wilshire 5000	9246.5	-1.2	-24.1	-31.4

SECTORS

	Sept. 26	Week	Year to date	Last 12 months
BusinessWeek 50*	668.9	-1.6	-31.1	-43.0
BusinessWeek Info Tech 100**	330.9	-2.0	-41.5	-62.1
S&P/BARRA Growth	513.6	-0.7	-25.3	-38.4
S&P/BARRA Value	493.5	-1.1	-22.4	-19.7
S&P Energy	724.1	-6.4	-22.3	-20.3
S&P Financials	132.0	2.1	-19.9	-16.2
S&P REIT	88.6	-0.8	0.7	3.5
S&P Transportation	539.3	-0.6	-22.7	-7.6
S&P Utilities	240.0	-6.7	-31.6	-27.1
GST Internet	71.4	-8.6	-60.7	-83.6
PSE Technology	506.0	-4.4	-37.9	-51.6

*Mar. 19, 1999=1000

**Feb. 7, 2000=1000

GLOBAL MARKETS

	Sept. 26	Week	Year to date
S&P Euro Plus (U.S. Dollar)	924.2	-1.0	-3.0
London (FT-SE 100)	4696.1	-0.5	-2.0
Paris (CAC 40)	3975.5	2.2	-3.0
Frankfurt (DAX)	4095.3	1.3	-3.0
Tokyo (NIKKEI 225)	9641.7	-0.4	-3.0
Hong Kong (Hang Seng)	9371.8	-2.0	-3.0
Toronto (TSE 300)	6654.8	-0.6	-2.0
Mexico City (IPC)	5324.8	1.3	-

FUNDAMENTALS

	Sept. 25	Wk. ago
S&P 500 Dividend Yield	1.53%	1.50%
S&P 500 P/E Ratio (Trailing 12 mos.)	33.1	28.5
S&P 500 P/E Ratio (Next 12 mos.)*	18.6	18.6
First Call Earnings Revision*	-4.88%	-2.43%

*First Call Corp.

TECHNICAL INDICATORS

	Sept. 25	Wk. ago
S&P 500 200-day average	1235.0	1243.4
Stocks above 200-day average	27.0%	38.0%
Options: Put/call ratio	0.86	0.96
Insiders: Vickers Sell/buy ratio	3.00	2.73

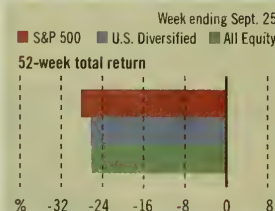
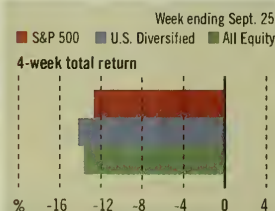
BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Defense Electronics	16.4	72.9
Gold Mining	7.3	66.4
Metal & Glass Containers	6.3	44.3
Regional Telephone Cos.	5.6	41.3
Tobacco	-0.5	34.4

WORST-PERFORMING GROUPS

	Last month %	Last 12 months %
Conglomerates	-40.8	Communications Eq.
Hotels & Motels	-34.0	Computer Systems
Specialty Appr. Retailers	-33.8	Semiconductors
Airlines	-33.4	Oil & Gas Drilling
Semiconductors	-32.6	Instrumentation

Mutual Funds



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-week total return	%	52-week total return	%
Leaders		Leaders	
Precious Metals	0.4	Precious Metals	18.7
International Hybrid	-6.1	Real Estate	5.7
Utilities	-7.6	Small-cap Value	1.2
Domestic Hybrid	-7.9	Mid-cap Value	0.9
Laggards		Laggards	
Technology	-22.0	Technology	-63.6
Latin America	-18.7	Communications	-57.9
Pacific/Asia ex-Japan	-17.8	Mid-cap Growth	-45.8
Mid-cap Growth	-17.6	Japan	-43.7

EQUITY FUNDS

4-week total return	%	52-week total return	%
Leaders		Leaders	
Rydex Dynamic Vent. 100	57.9	Potomac Internet Short	273.5
ProFunds UltraShort DTC	57.7	Rydex Dynamic Vent. 100	229.2
Prudent Bear	29.7	ProFunds UltraShort DTC	216.6
Rydex Dynamic Temp. 500	29.3	Rydex Arkots Investor	124.9
Laggards		Laggards	
ProFunds UltraDTC Inv.	-40.9	ProFunds UltraDTC Inv.	-93.0
American Heritage	-33.3	Berkshire Focus	-89.5
Berkshire Focus	-32.7	Berkshire Technology	-89.4
Berkshire Technology	-32.4	Potomac Internet Plus	-87.3

Interest Rates

KEY RATES

	Sept. 26	Week ago
MONEY MARKET FUNDS	3.03%	3.22%
90-DAY TREASURY BILLS	2.38	2.19
1-YEAR TREASURY BILLS	2.48	2.49r
10-YEAR TREASURY NOTES	4.65	4.69
30-YEAR TREASURY BONDS	5.50	5.56
30-YEAR FIXED MORTGAGE†	6.67	6.72

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 31% federal tax rate.

	10-yr. bond
GENERAL OBLIGATIONS	4.11%
TAXABLE EQUIVALENT	5.96
INSURED REVENUE BONDS	4.30
TAXABLE EQUIVALENT	6.23

THE WEEK AHEAD

PERSONAL INCOME Monday, Oct. 1, 8:30 a.m. EDT ► Personal income likely grew 0.3% in August, after increasing 0.5% in July. That is the median forecast of economists surveyed by Standard & Poor's MMS, a unit of The McGraw-Hill Companies. Consumer spending in August probably grew 0.3%, after rising 0.1% in July.

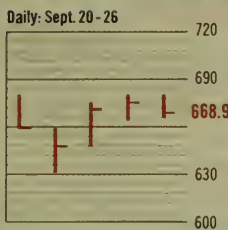
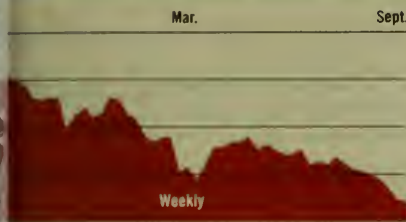
PURCHASING MANAGERS' INDEX Monday, Oct. 1, 10 a.m. EDT ► The National Association of Purchasing Management's September index of industrial activity is projected to have slipped to 45.5%, after jumping to 47.9% in August.

FOMC MEETING Tuesday, Oct. 2, 9 a.m. EDT ► The Federal Reserve Board's Open Market Committee will meet to set monetary policy. A majority of economists surveyed by S&P expect another 50-basis-point cut in the federal funds rate.

FACTORY INVENTORIES Thursday, Oct. 4, 10 a.m. EDT ► Manufacturing inventories are forecast to decline for a seventh consecutive month, by 0.6% in August, after a 0.6% drop in July.

EMPLOYMENT Friday, Oct. 5, 8:30 a.m. EDT ► Nonfarm payrolls likely declined 70,000 jobs in September, while manufacturing is expected to show a 75,000 jobs. The unemployment rate in September likely hit 5.0%.

INSTALLMENT CREDIT Friday, Oct. 5, 8:30 a.m. EDT ► Consumers probably pared off \$2 billion of debt in August.

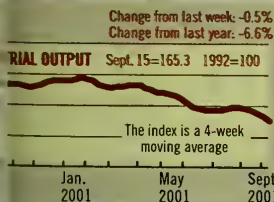


of AES, the electric-power giant, short-circuited after warning that profits would not meet while the rest of the BW 50 recovered a bit from the previous week's lows, investors remained cautious. Stronger signals from Washington on the economic as well as military front. Financials Citigroup, Morgan Stanley rose 2.2%, 4.6%, and 3.9%, respectively.

COMPANY PERFORMANCE

Company	% change		Rank	Company	% change	
	Week	Since 3/1/01			Week	Since 3/1/01
International	1.0	-19.1	26	Verizon Communications	0.0	11.3
Petroleum	-6.3	-30.6	27	Citigroup	2.2	-19.2
	-12.7	-52.0	28	Sun Microsystems	-7.3	-57.9
	-4.7	-31.3	29	Merck	-6.6	-20.6
Materials	-6.4	-35.7	30	El Paso	-13.2	-45.3
Financial	-6.5	-60.9	31	Altera	-20.5	-35.4
Petroleum	-8.0	-5.0	32	Marsh & McLennan	12.6	-11.9
	-7.5	-34.6	33	Household International	2.5	-8.2
See	-8.5	-26.0	34	Chevron	-7.2	-9.3
	8.9	-42.9	35	SBC Communications	4.5	4.0
Brothers Holdings	4.6	-21.3	36	Mercury Interactive	-10.0	-68.3
	1.0	-70.4	37	AOL Time Warner	4.2	-26.7
	-47.1	-77.6	38	Washington Mutual	0.0	11.6
Laboratories	4.9	6.1	39	General Dynamics	3.1	27.3
Financial	-1.0	-16.6	40	Comcast	1.2	-20.9
Technology	-26.4	-51.9	41	Morgan Stanley Dean Witter	3.9	-31.4
	-25.8	-47.9	42	Tellabs	-2.1	-75.8
Hess	-14.3	-17.8	43	Exxon Mobil	0.0	-5.6
Energy	-3.5	-11.6	44	Scientific-Atlanta	-6.2	-63.8
Communications	0.6	-71.9	45	U.S. Bancorp	-1.2	-8.6
Financial	9.2	-21.6	46	Paychex	-6.9	-25.8
Petroleum	-4.6	-5.8	47	Merrill Lynch	-1.3	-36.7
Devices	-3.2	-20.3	48	Bed Bath & Beyond	15.6	0.1
Services	-5.2	-39.0	49	Texas Instruments	-0.6	-26.7
Health	1.1	5.3	50	Teradyne	-18.5	-36.6

Production Index



On index dropped significantly over the before calculation of the four-week moving index tumbled from 165.1 to 163.4. On a adjusted basis, auto and truck assemblies best, as the Sept. 11 attacks delayed parts caused plant shutdowns. Electric power, de-oil refining were lower as well. Despite n interruptions, rail-freight traffic was week, along with coal and lumber.

Each of the index components is at www.businessweek.com. Production index Copyright 2000 by The McGraw-Hill

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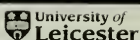
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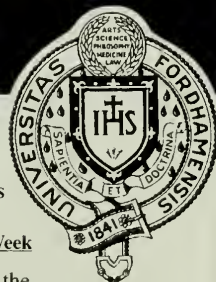
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THE WORLD COULD COME OUT A WINNER

The prospect of war invariably changes the geopolitical landscape. The U.S.-led battle against terrorism appears to be of such scope and scale that it will be no exception. We already see changes in the Bush Administration's early unilateralist approach to foreign policy as the country seeks overseas allies in its search for Osama bin Laden. Indeed, it is to President Bush's credit that he has found the voice of leadership in troubled times and the courage to dramatically change course to achieve new national political and military goals. At a time of deep mourning for the thousands who died by terrorist hands and great uncertainty about what may unfold in the weeks and months ahead, we should remember that the world can come out of conflict a better and safer place. There are already signs of a geopolitical realignment under way that may do just that. The Bush Administration's fine calibration of foreign policy may, at the end of a very dark day, produce an international scenario surprisingly ripe with promise and opportunity.

Take Russia. President Bush's early courting of President Vladimir V. Putin is paying big dividends. Putin is offering great help to the U.S., from airfields in Central Asia to sharing intelligence data on bin Laden's network. He is promising to send arms to the Northern Alliance in Afghanistan, which opposes the Taliban, and use Russian troops to help in search-and-rescue operations if American aircraft are shot down. This could be the start of a much

bigger alliance leading to a vast reduction of nuclear arms, U.S. investment in Russian oil fields and industries, and the eventual entrance of Russia into the World Trade Organization and perhaps even NATO. This would truly lay the Cold War to rest.

Relations with Iran could improve substantially as well. Some 77% of the Iranian electorate recently voted for reformist President Mohammed Khatami, voicing their desire to reject religious fundamentalism and open the country to the West. Yet anti-American clerics continue to control the judiciary, the military, and terrorist training camps. Khatami's government strongly condemned the terrorist attacks, and the U.S. Reformist mayors in Tehran and Isfahan sent messages of condolence. If Iran chooses to help Washington against bin Laden and the Taliban, the move could open the door to a deal that provides Khatami with the resources to dislodge the clerics from their positions and ends the country's support of Hezbollah and other terrorist groups. This could change the balance of power in the Middle East for the better.

The fog of war is greatest at the beginning, and the battle against terrorism is murkier still. But as the tectonic plates of geopolitics change through the upcoming conflict, there is promise that the U.S. could lead the world to a better place. In the face of tragedy, the Bush Administration is off to a very good start.

HOW BEST TO PRIME THE PUMP

An enduring legacy of Keynesianism is the understanding that in times of crisis, government must step in to help the economy. The Sept. 11 attacks, coming on top of a deep slump in business investment, have created a crisis in confidence and a widespread fall in business and consumer spending. It's important for Congress and the Administration to craft a realistic plan for pumping money into the slumping economy.

Part of those new funds, perhaps \$80 billion this year, will come in the form of added defense spending and emergency disaster assistance. Beyond that, Washington needs to pass tax cuts that address the problems of weak business investment and worried consumers. That would provide an insurance policy in case the current slump turns out to be longer and deeper than economists now expect.

The questions then are how much the fiscal stimulus package should be and what kind of tax cuts would be the best to pass. On the first point, fast is better than big. Federal Reserve Chairman Alan Greenspan urged Congress to wait for more information before acting. But any delay beyond a few weeks is worrisome. Any cuts need to be in place as soon as possible if they are to help in 2002.

Moreover, they should be primarily focused on next year.

The tax-cut plan should be two-pronged. On the investment side, the best proposal is probably accelerated depreciation and expensing for 2002. That would cut the aftertax cost of new equipment and buildings for companies and stimulate investment. On the consumer side, one good option is a refundable income-tax credit for payroll taxes paid for next year. That would put more money into the hands of low-income workers likely to be hit hard by the slowdown.

True, fiscal stimulus is no panacea for economic weakness. Just look at Japan, which started running massive government deficits in the second half of the 1990s. The spending, much of it on unneeded infrastructure projects, kept the Japanese economy afloat in the short run, but did nothing to deal with the larger structural problems that the Japanese economy faced.

But the U.S. is not Japan. The U.S. economy is basically solid, and the Federal Reserve is fighting the slowdown far more aggressively than the Bank of Japan ever was. Facing a short-term crisis, strong fiscal stimulus is exactly the right thing to do.



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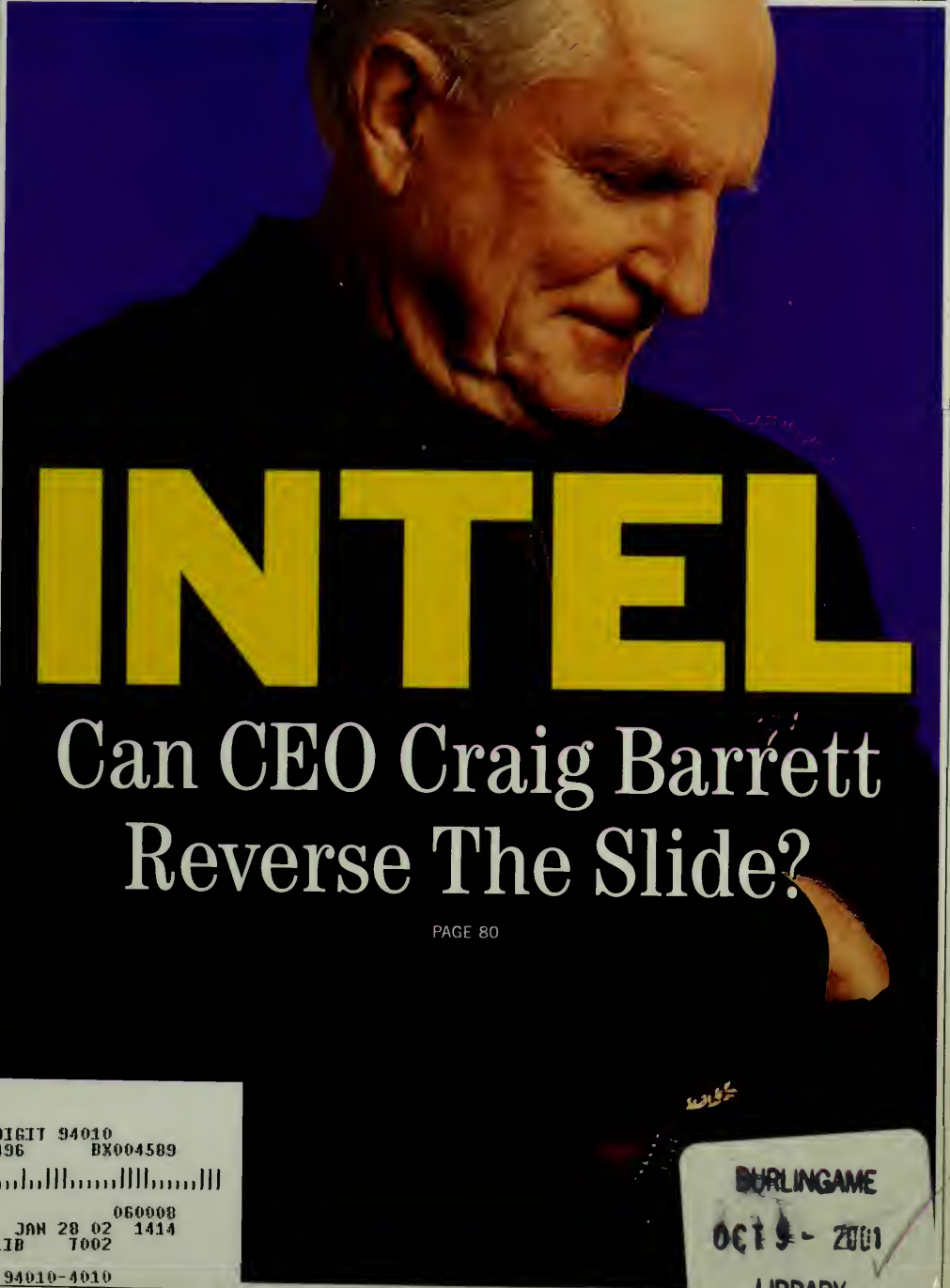
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The chipmaking giant has spent \$10 billion on a bold diversification strategy. So far, all that dough has produced little page 80

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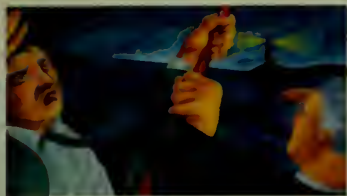
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Tracking the Tremors

As the aftershocks of September 11 linger, BusinessWeek Online continues its daily coverage with analysis and commentary



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Up Front

EDITED BY SHERIDAN PRASSO

ECONOMIC FALLOUT

THE HIT TO PRODUCTIVITY

ONE OF THE MOST IMPORTANT questions of this whole terrorism mess is one that defies answer: How much is it costing in lost output? For the last decade, productivity gains by American workers have

business shuttered and millions watched their TV sets in horror. Since then, regular commerce has been returning, but not without security delays—at airports, at U.S. borders, in office buildings, on roadways, anywhere the public must congregate or pass.

The time demands are virtually impossible to measure. But consider a simple exercise that economists say gives an idea of the losses: An estimated 70,000 passengers now board planes at O'Hare International Airport every day. If half of them are business travelers making an average \$80,000, and they spend an extra hour passing through security, the value of their time is \$40 per person—or \$1.4 million a work day. In a year, that's \$365 million in Chicago alone. Now multiply that for every business traveler in the country. It's a huge drag on any economy. *S. P.*

CHECKPOINT: Slow going

fueled the spectacular growth of the New Economy. The attacks, at least temporarily, have thrown that into reverse. The U.S. ground to a halt on September 11, as busi-

TRUSTBUSTERS

THE MICROSOFT STANDOFF

IN A HALLWAY CONVERSATION AT THE Justice Dept. on Sept. 21, antitrust chief Charles James was asked if the terrorist attacks would increase the odds of a settlement of the Microsoft case. Prior Administrations have used foreign policy and national security arguments to justify ending lengthy antitrust litigation. But James dismissed the idea, saying: "Show me the foreign policy implications of the Microsoft case."

The new judge, however, has brought the issues together. Citing the events of September 11, Judge Colleen Kollar-Kotelly directed the two sides to start immediate settlement talks and devote every available hour to reaching agreement. "In light of the recent tragic events affecting our nation, this court regards the benefit which will be derived from a quick resolution of these cases as increasingly significant," she wrote.

Will that make the trustbusters weaken their demands on Microsoft? While it does give the Bush Administration political cover to settle a case it never liked anyway, difficult issues remain to be ironed out. And Microsoft has shown little sign of budging.

Dan Carney



TALK SHOW "We've got statisticians who will be crunching the numbers.... But we don't need numbers to tell us people are hurting."

—President George W. Bush, on the economy

RUMOR MILL

PUTTING A HEX ON E-HOAXES

THE E-MAIL SOUNDED SCARY, warning of blue envelopes randomly mailed to people, containing a deadly dysentery virus. Another warned of new dates for new attacks. At a time when our shattered nerves will let us believe almost anything, we are being bombarded by warnings: some well intentioned, some malicious, and many—like these—bogus.

Before you spread panic by forwarding warnings to everyone you know, try to make sure the threat is legitimate. Fortunately, it's easy to check. The government's Centers for Disease Control & Prevention main-

tains a Web site, www.cdc.gov/hoax_rumors.htm, health-related hoaxes. It knocks down the virus-in-mailbox hoax, which has been around since spring. It gained new currency after September 11. Computer viruses easily spread via e-mail, have seen a spate of both hoaxes and genuine threats. Again, the government offers a Web site: Hoaxbusters, run by the Energy Dept. Computer Incident Advisory Capability (hoaxbusters.org). In addition, antivirus software makers such as Symantec (www.symantec.com/avcenter) and McAfee (www.mcafee.com/avcenter) offer info and advice on current threats. So next time you get a scary message, check it out before sending it on. *Stephen H. Wildstrom*

WHAT TO BELIEVE?



THE LIST SHOW-BIZ SCRAMBLE

Hollywood, reflecting the change in the public mood, has delayed release dates, cut content deemed inappropriate, and scrapped projects. Some examples:

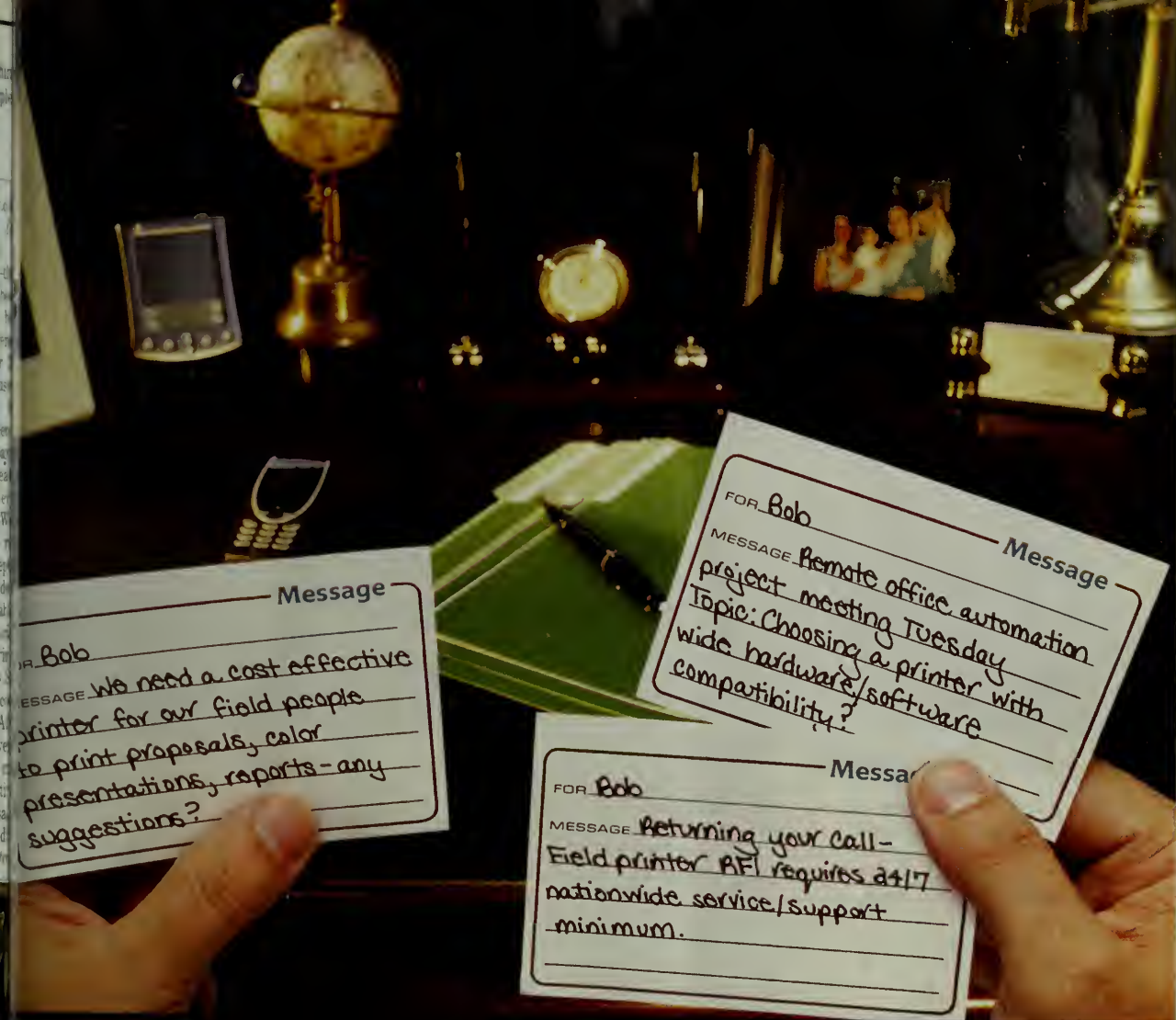
MOVIE/STUDIO

TRAINING DAY WARNER BROS.	Denzel Washington cop drama; delayed two weeks
MEN IN BLACK 2 COLUMBIA PICTURES	Will Smith and Tommy Lee Jones sequel; new ending won't feature WTC
COLLATERAL DAMAGE WARNER BROS.	Arnold Schwarzenegger plays a firefighter avenging the deaths of his wife and child in a bombing; delayed indefinitely
BIG TROUBLE TOUCHSTONE	Tim Allen comedy; delayed indefinitely due to scene involving a bomb on an airplane

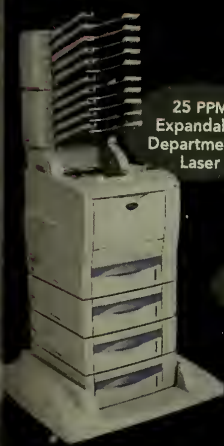
TV SHOW/NETWORK

THIRD WATCH NBC	Filming delays push back season premiere of show featuring NYC firefighters and police
THE AGENCY CBS	New show revised its pilot; old plot involved terrorism, mentioned Osama bin Laden
LAW AND ORDER NBC	Special miniseries, <i>Terror</i> , about bioterrorism against NYC was scrapped; posters changed
24 FOX	Show's premiere had featured an explosion on an airplane; scene cut
THE WEST WING NBC	Season premiere delayed and rewritten to reflect tragedy





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ADVERTISING

CONDOLENCE ADS LIFT NEWSPAPERS

PART OF THE ECONOMIC FALL-out from the terrorist attacks is that the nation's 9,000 daily and weekly newspapers are certain to see fewer ad dollars over the next year. Under a revised forecast, released on Sept. 19 by media newsletter *The Meyers Report*, ad spending in newspa-

ter the attacks, condolence ads have poured unexpected revenue into advertising coffers. "I'm not sure the memorial ads have made up the difference, but they've certainly helped," says Steve Howe, vice-president for advertising at *The Wall Street Journal*, which has run more than 100 of the special ads since September 11. A full-pager costs \$162,000, but regular advertisers get discounts. "This was necessary to do," says Massimo Ferragamo, president of the U.S. operation of fashion house Salvatore Ferragamo. Its 7-inch-high ad read simply: "We salute the United States of America" and ran in *The New York Times*, the *Los Angeles Times*, and the *Chicago Sun-Times*. "In our case, we felt less would say more," he says. Even small-town papers have been helped by ads from local businesses.

The memorials also have given advertisers time to figure out how to proceed with marketing. "There's almost an intangible fear on the part of anyone to appear as if they are profiteering," says John Kimball, marketing director for the Newspaper Association of America. In the meantime, member newspapers are grateful for the temporary boost. *Tom Lowry*

TAKING UP THE SLACK: Recent pages

pers is expected to decline 5% in 2002, vs. a pre-attack estimate of a 2% drop.

For now, though, some of the dive in advertising has been buffered by slews of memorial and condolence ads taken out by everyone from Saudi Arabia to Tiffany. At a time when publications feared that advertising would halt af-

THE BIG PICTURE



GOOD INTENTIONS

Americans want businesses to help the victims of the terrorist attacks, but they're wary of companies that solicit from employees or customers.

PERCENTAGE OF AMERICANS THAT SAY IT IS APPROPRIATE FOR COMPANIES TO:

GET BACK TO BUSINESS AS USUAL	75%
HOLD FUND-RAISERS FOR SEPTEMBER 11 VICTIMS	74%
ASK EMPLOYEES TO DONATE TO A SEPTEMBER 11 FUND	51%
ADVERTISE THEIR EFFORTS TO HELP SEPTEMBER 11 VICTIMS	51%
ASK CUSTOMERS TO DONATE TO A SEPTEMBER 11 FUND	50%

Telephone survey of 1,015 adults, Sept. 21-24
Data: Cone Inc.

DRAWN & QUARTERED



INVESTING

AFTER THE ATTACKS, A GOLD RUSH

WITH UNCERTAINTY IN THE markets and interest rates falling, many investors are wondering if there's any refuge for their money. Some think they've found it in gold. The U.S. Mint sold well over 60,000 gold coins in the two weeks after the September 11 attacks—10 times the amount sold in September last year. Those numbers may even understate the demand for the coins, since gold that was hoarded in anticipation of a Y2K disaster has been coming out of desk drawers and mattresses and back into the market since Jan. 1, 2000.

The "survivalists" are certainly doing their share to buoy the gold market. A somewhat older crowd living mostly in Western states, they're intent on being self-

sufficient if the U.S. government collapses, and they want to own gold in small-denomination coins in case the financial system fails. Their purchases are up at least fivefold since the attacks, says Leonard Kaplan of commodities broker and money manager Prospector Asset Management.



U.S. COIN Demand is way

But most of the recent demand for gold comes from wealthy investors who are using the coins as a hedge. Sure, gold has been a lousy investment for the past 20 years, exceeds Richard Smith, president of the Coin & Stamp Gallery in Phoenix. But with the stock market reeling, an investment that's merited "lousy" is starting to look pretty good. *Kimberly We*

HELPING OUT, ONLINE

Charity Web sites usually record only modest amounts of traffic. But since September 11, those accepting online donations have been among the most viewed Web sites in the U.S.

SITE	VISITS
REDCROSS.ORG	1,658,000
HELPING.ORG	1,472,000
TRIBUTETOHEROES.ORG	1,212,000
LIBERTYUNITES.ORG	560,000
SEPTEMBER11FUND.ORG	168,000

*Sept. 10-23
Data: Nielsen/NetRatings, Jupiter Media Metrix

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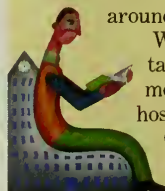
Stock Exchange and from the magazine's editorial offices in New York. Bill Tucker, an award-winning CNN and CNNfn correspondent, is managing editor and co-host with veteran anchor Jill Bennett. Reporters and editors from *BusinessWeek*'s world-

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RANKING THE BEST EMBA PROGRAMS

For mid-career executives, *BusinessWeek*'s ranking of best Executive MBA programs is the counterpart to our hugely popular biennial ranking of the Best B-Schools (BW—Oct. 2, 2000). Every two years since 1991, we have published the results of our survey of EMBA program directors as a benchmark of the top programs. This year, with the addition of a customer-satisfaction survey of more than 5,000 recent graduates of EMBA programs, we rank the 25 best programs around the world.



With the growing importance of global business, more U.S. schools are hosting programs abroad. Others have formed joint programs with in-

ternational counterparts. While our B-school rankings focus on full-time programs, our EMBA rankings are geared toward part-time degree programs for senior executives, many of whom are sponsored by their corporations.

Our report also ranks the Top 20 non-degree executive education programs among 121 schools. For this, we surveyed corporate management and development directors, who send executives to customized and open-enrollment programs.

You will find a wealth of information in our survey. More data can be found at (www.businessweek.com/bschools/).

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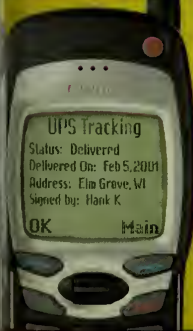
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Readers Report

VESTMENT MAY BE THE GHT ANTIDOTE TO TERRORISM

Your coverage of the economic impact of the Sept. 11 attack will be reread in my economics principles class now under way ("Rethinking the economy," Special Report, Oct. 1). The histories of many countries, e.g., Poland, provide ample evidence that ruling people will continue to heed calls for political radicalism, terrorism, or violence in places where no hope for economic or political betterment exists at the economic bottom.

After we take the revenge we feel we must and build the electronic security Maginot Line we naively think will protect us, the federal government and/or the global business community could fund, set up, and actually run a global network of Small Business Administration-style venture-capital organization with branches in medium to large cities in impoverished countries. Offering might come from specially trained Peace Corps-style volunteers drawn from the ranks of experienced trained managers. If we really believe that capitalism is the best long-run answer, let's provide some capital.

Thomas P. Egan
Moravian College
Bethlehem, Pa.

ABS MUST ROOT OUT E CANCER IN THEIR MIDST

"Bush's fragile coalition" (Special Report, Oct. 1) need not be fragile if the so-called friendly Arab nations decide to do themselves a favor by working with us to remove the "terrorist cancer" that they have been harboring for some time. This will be the beginning of the end of their own regimes unless they act in concert with us as true partners for their own safety. The Administration's task must be to hammer this point over and over. (They may still choose to dislike our way of life if they so desire.)

Zaven S. Touloukian
Camden, S.C.

KING THE LEAD RELIEVE SUFFERING

CEOs need to be leaders in this time of national crisis ("What must be done," Editorials, Sept. 24), but leadership must go beyond traditional concerns of employment and the economy. The most serious threats to capitalism are failures of liberty, human rights, and civil justice. [CEOs] can lead by learning how to orient their business operations to

CORRECTIONS & CLARIFICATIONS

"The new Netrepreneurs" (e.biz, Cover Story, Oct. 1) erred in saying CNET Networks Inc. received "a paltry \$5 million" from NBC for Web portal Snap.com. NBC paid \$5.9 million for 19% of the portal, and then later paid \$32 million for 60%, taking control. Later, after NBC merged Snap.com with other Internet assets and took them public as NBCi, CNET sold its shares in that company for \$112 million.

In "Strong words. Tasty, too" (e.biz, Oct. 1), a quotation by Geoff Yang of Redpoint Ventures was accompanied by an incorrect photo. Here is Yang's photo as it should have appeared.



support freedom and justice, and by serving as exemplars within their industries. When the aggrieved people have legitimate and equal opportunity, the terrorists have no voice.

Donna J. Wood
Pittsburgh
Jeanne M. Logsdon
Albuquerque

Before we kill a single person, I want the U.S. to commit \$100 billion to a fund dedicated to the elimination of poverty, hunger, disease, and ignorance in the Middle East. I want our President and other leaders to challenge the Europeans, the Japanese, and the rich countries of the Middle East and elsewhere to triple these funds using their own resources. Together, we will reduce the crushing debt in these societies, build schools and homes, feed the hungry, eliminate disease, and otherwise attack the conditions that gave birth to such a deep vein of hatred in these societies.

For the countries that want this support, the price will be a concerted effort to eradicate the forces of hate that are breeding inside their societies. We can give their leadership the resources to do it themselves, not in the name of some foreign faith, but in the name of the humanity of the true Islam.

Gordon S. Black
Rochester, N.Y.

If we are concerned about suffering in the Middle East, as we should be, it should be of all the people, including ordinary Israeli citizens who have endured years of terror for so many years. We should press Palestinian and Arab leadership in all the countries to absorb the Palestinians the way that Israel ab-

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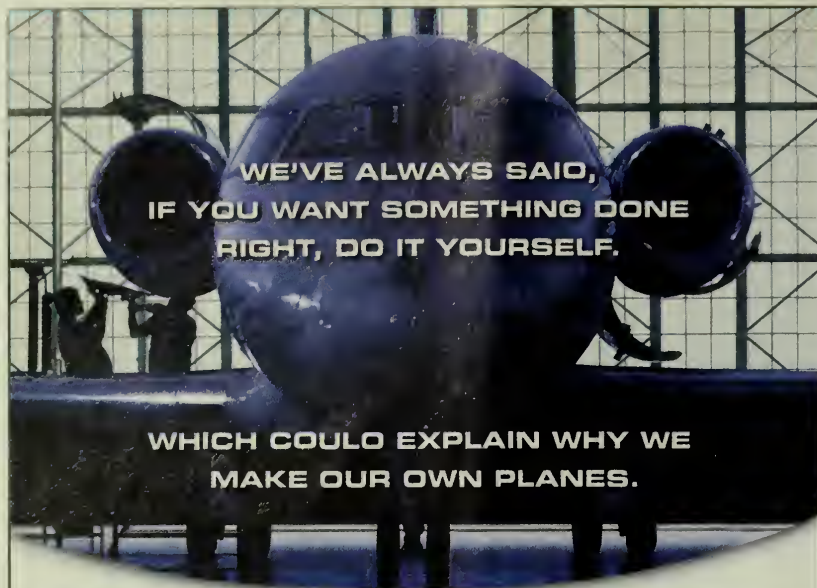
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Readers Report

sorbed all the Jews of Arab lands, and to make a full, cooperative, and fruitful peace with Israel. Then the region can go forward and bring peace and prosperity to all.

J. Fires
Port Washington, N.Y.

BIN LADEN SHOULD FOOT THE BILL FOR DAMAGE

Insurance companies should file a claim on funds confiscated by the American government ("A ruinous day for insurers," Special Report, Sept. 24). Although the dollar amount of assets the U.S. has frozen is minuscule compared with the cost of the damage, it would be a feel-good gesture to us Americans that Osama bin Laden is paying for some of the devastation out of his own pocket.

Mark Newhouse
Brooklyn, N.Y.

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 Judith Miller, Stephen Engelberg, and William Broad
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BIO-TERRORISM UNDER THE MICROSCOPE

In September, 1984, a severe outbreak of salmonella poisoning hit The Dalles, Ore., a town of 10,000 in the shadow of Mt. Hood. Almost 1,000 people reported symptoms, and although one died, every one of the 125 beds in the town's only hospital was filled, and patients were stacked up in the corridors. Investigators from the U.S. Centers for Disease Control & Prevention (CDC) were called in, but despite checking every possible source, no one could find the cause of the outbreak.

It was only a year later that Bhagwan Shree Rajneesh, the founder of a large cult with a settlement on the edge of town, told authorities that one of his followers caused the outbreak by spraying salad bars around town with salmonella. The perpetrators, angry about efforts by the town to check expansion of their 4,000-member community, had fled the country days before Rajneesh's announcement, but law-enforcement agents soon discovered evidence the group had been busy developing plenty of other chemical and biological weapons. "Call us naive," said one of the first victims of the salmonella attack, "but we never imagined people could have done such a thing. You don't expect bio-terrorism in paradise." Welcome to Paradise Lost. This chilling account of the salmonella attack—the only known instance of bio-terrorism on U.S. soil—recounted in the opening chapter of *Germes: Biological Weapons and America's Secret War*, by *New York Times* reporters Judith Miller, Stephen Engelberg, and William Broad. It's a timely and sobering primer on the threat we all suddenly come to fear. Granted, serious defense experts, Nobel laureates, government officials, and even Hollywood movies have been warning for years that an attack on the U.S. with biological weapons is a very real danger. But the public paid little heed until we

learned in catastrophic detail just how deadly terrorists can be. Now, a recent *Newsweek* poll finds that 86% of Americans think a bio-terrorist attack is at least somewhat likely.

Miller, Engelberg, and Broad's book is an ominous, if somewhat conflicted, view of bio-terrorism. Its greatest virtue is its lack of hysteria: The authors recount the arguments of defense experts who think a biological-weapons attack is unlikely side by side with those of scientists who fear nothing more intensely.

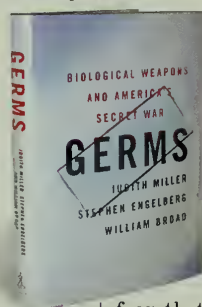
But the authors' own conclusion is a somewhat befuddling acknowledgement that the threat of germ weapons is both real and exaggerated. Despite this seeming contradiction, their steadfast insistence on balance enhances the book's veracity as it recounts the many efforts around the globe to develop bio-weapons—including in the U.S.

Some of the material may sound familiar after the extensive coverage that bio-terrorism has received in the wake of the Sept. 11 attacks. But *Germes* is one of the more reliable sources of information on this 21st century worry: There are 42 pages of notes and a bibliography, and the authors interviewed dozens of players across the globe, including former President Bill Clinton.

Much of the book retells the history of biological weapons, starting with a massive and secret U.S. program that began in the 1950s. (There was one earlier experiment: a failed effort to poison a suspected Hitler henchman who turned out to be an anti-Hitler plotter). The U.S. stopped its own development of such weapons in 1969 and signed an international ban on bio-warfare in 1975. But the Soviet Union kept going, despite signing the same ban. It was only

in 1992, thanks to the defection of a prominent Soviet scientist, that the U.S. learned of Moscow's massive, decades-long program to turn deadly bugs such as anthrax, tularemia, typhus, and plague into weapons. The program was ended in the early 1990s, and the labs dismantled, but the scientists who had worked there were aggressively courted by Iran and Iraq, the authors report.

Iraq's efforts to develop biological weapons have been well covered in the past, and *Germes* adds little to the story. The book breaks new ground, however, in its detailed account of Clinton's determination to bolster the nation's bio-terrorism defenses. The first President to declare bio-weapons a real threat to domestic security, Clinton persuaded Congress to appropriate \$10 billion a year to defend the nation against terrorism, including \$381 million for research into dangerous pathogens. Some of this money was funneled to secret CIA and Pentagon programs to develop



a better understanding of weapons and delivery methods engineered by foreign scientists. The CIA's Operation ClearVision figured that the best way to outsmart the enemy was to emulate it by reverse-engineering a bio-weapon. In essence, the CIA was building its own bio-bomb, and the effort was eventually shut down out of

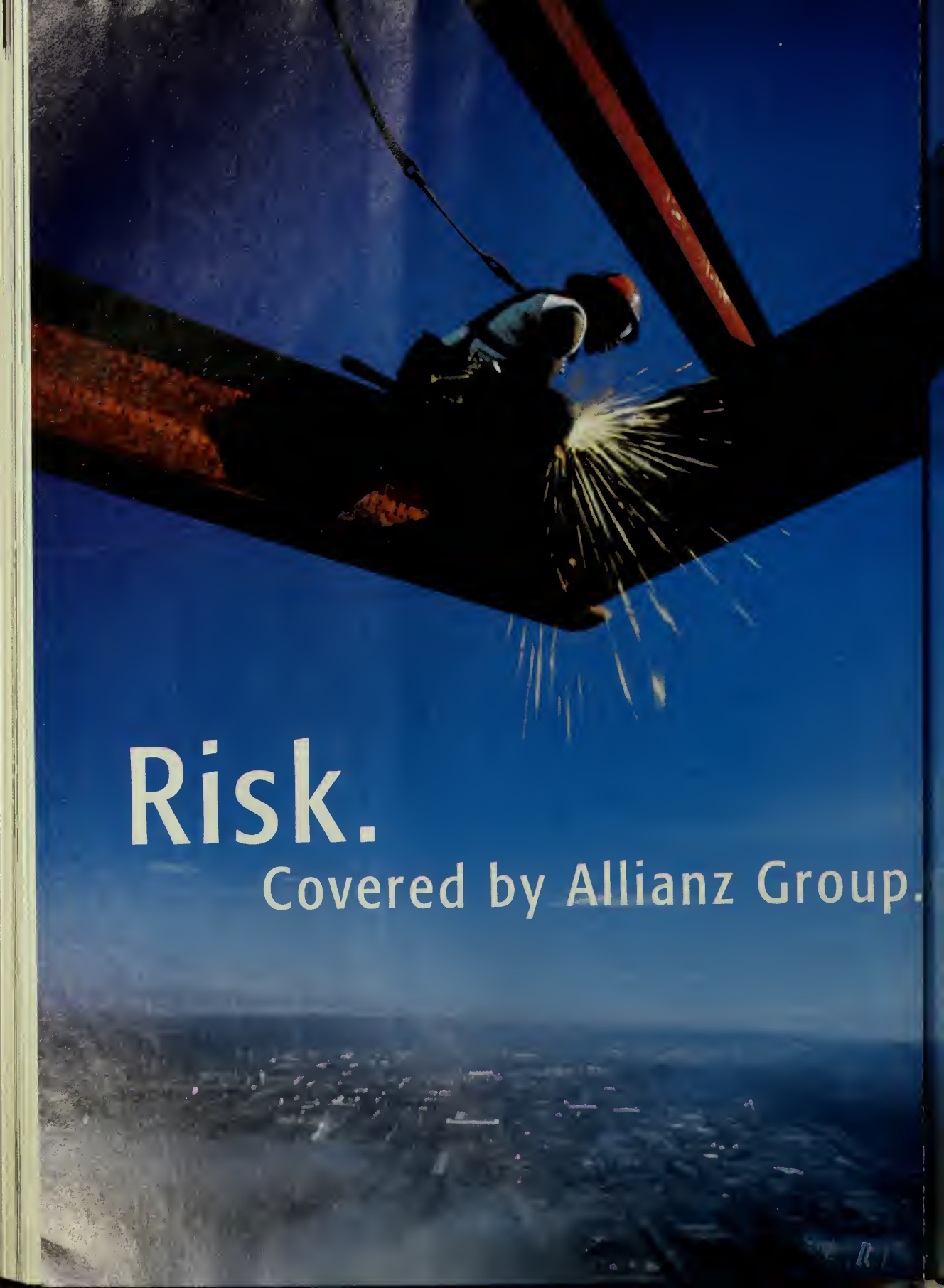
fear that it came dangerously close to violating the germ warfare treaty.

The final chapter of *Germes* is the most provocative: a detailed look at America's ability to ward off a bio-attack. Clinton's anti-terrorism program included a renewed effort to beef up the public health system, which had fallen into disarray over decades of neglect by federal and local governments. But government simulations of germ warfare show that we remain woefully unprepared. The U.S. today is in some ways less able to protect the population against an outbreak of deadly disease than it was a half-century ago, conclude the authors. As evidence, look at that lone hospital in The Dalles. When the Rajneeshes struck in 1984, it had 125 beds. Today, it has 49.

BY CATHERINE ARNST

Senior Writer Arnst covers medicine and science.

THE THREAT OF GERM WEAPONS IS BOTH REAL AND EXAGGERATED, SAYS THIS BALANCED BOOK



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BY STEPHEN H. WILDSTROM

tech&you@businessweek.com

WHAT'S MAKING PALM SWEAT



Three new PocketPCs offer improved battery life, networking, and memory capacity

The PocketPC began life as a very ugly duckling. But if the clunky "Palm-size PCs" of 1998 haven't quite turned into something beautiful, the latest versions built on Microsoft's new PocketPC 2002 software have at least become a flock of attractive and useful handheld computers.

I checked out three brand-new models, the Hewlett-Packard Jornada 560, on sale starting Oct. 4, and the Compaq iPAQ 3800 and Toshiba e570, which appear in a few weeks. Although all share the same basic software, a 240-by-320-pixel color display, and an Intel Strong-ARM processor (Technology & You, Oct. 1), each offers its own strengths.

When the first iPAQ model came out last year, its sleek design made it the star of the field, and it remains the sharpest-looking and the most versatile of the class. While the weight has dropped a smidge, to 6.5 oz., the iPAQ has gained its first internal storage slot, which uses the same memory cards used in Palms. Although the slot currently can only be used to add memory, Toshiba is about to offer a card that provides short-range Bluetooth wireless communications with other devices, such as cell phones.

BRIGHTEST. For broader networking options, iPAQ retains a system of accessory "sleeves" that slide onto the iPAQ and let it accept either CompactFlash or PC Card accessories. This gives the iPAQ the broadest range of communications choices, from standard telephone modems to wired or wireless Ethernet to wireless phone network access. There's a price for this flexibility, though: The sleeves, especially the PC card unit, add a lot of weight and bulk to the sleek iPAQ.

The iPAQ also continues to have the brightest screen of the bunch. But be careful. You have to turn the brightness down if you want to get the claimed 10-hour battery life. And in a small but important change, the stylus storage slot is less prone to jamming.

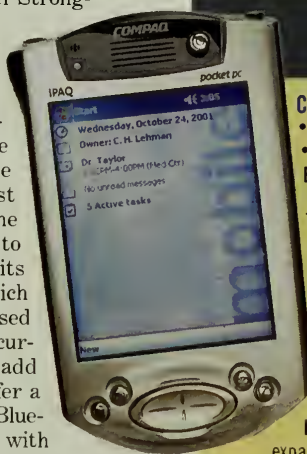
The new Jornada marks a big improvement from last year's 540 series. Although it's about the same size as its predecessor, it has lost nearly three ounces of weight. It retains the flip-up cover of the earlier version, but the odd "popsicle stick" stylus that was stored inside the cover

has been replaced by a conventional round stylus kept in the body of the unit.

The most important change is a frontal attack on the PocketPC's weakest point, battery life. Batteries on the older versions lasted 8 to 10 hours. But despite a much brighter screen, HP promises up to 14 hours power on a charge, enough for several days of use. Better yet, it's the only PocketPC with a removable battery, so you can carry a spare, and HP will offer an optional bigger battery with double the life.

It's not clear what will happen to the iPAQ and Jornada lines if and when the planned Compaq-HP merger is consummated. Officials of both companies declined to speculate. Since each product has been adopted as a corporate standard by various companies, both may survive, at least for a while. A PocketPC combining the best features of both might be the ultimate handheld.

Toshiba's e570 (sold in Asia as the Genio) is the big Japanese computer maker's first entry into the handheld arena. Its design is conservative—basically, a rectangular box. Its most interesting feature is that it has slots for two



The New Crop of Pocket PCs

COMPAQ iPAQ 3800 (SHOWN)

- \$599
- 5.3X3.3X.6 IN., 6.7 OZ.
- BEST FEATURE:** Accessory sleeves, which give it greatest flexibility of any PocketPC

HEWLETT-PACKARD JORNADA 565

- \$599
- 5.2X3.0X.7 IN., 6.1 OZ.
- BEST FEATURE:** Removable battery with extended-life option

TOSHIBA E570

- \$569
- 4.9X3.0X.7 IN., 6.3 OZ.
- BEST FEATURE:** Built-in slots for two types of expansion cards

types of expansion cards, SD and CompactFlash.

The bigger CompactFlash cards are being used for a lot more than memory. Until recently the only way to get a PocketPC onto a wireless local area network—great for reading e-mail during boring meetings—was to use the iPAQ with a PC Card designed for a laptop. But Symbol Technology now offers the Wireless Networker, a \$150 CompactFlash card that can get any PocketPC onto a wireless LAN that uses the Wi-Fi standard. It's much less power-hungry than the PC Card version, with Symbol estimating it will reduce battery life by about 15%, compared with about 50% for a Wi-Fi PC Card.

While Palm and its partners still dominate the market for handhelds, these products show why the PocketPC is coming on strong. And additional models are on the way, including one from NEC and a more consumer-oriented version from Casio. Competition and technological innovation are combining to make handhelds powerful and versatile tools.

BusinessWeek online

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BY ROBERT KUTTNER

THE ECONOMY NEEDS MORE BIG GOVERNMENT—NOW



REFOCUS:
Repeal
high-income
tax cuts.
Instead,
spend at
least \$300
billion this
year and
next on
security and
the social
safety net

September 11 suddenly shook America out of its complacency about terrorism—and also reversed two decades of bipartisan contempt for government. Now, with a gathering economic storm, government again has an enlarged economic role as well as a military one.

The economy was in trouble well before the attacks because of a rare collision of forces. The stock market bubble had burst, not just because of the tech collapse but because of weak earnings across the board. A huge amount of excess production capacity weighed down the economy, and investment imploded.

By July, consumer borrowing, which had kept the economy out of recession, also was pulling back. Unemployment abruptly spiked to 4.9%, with manufacturing taking the worst hit. Repeated rate cuts by the Fed were achieving little.

Then came the attack—and with it a real danger of economic free fall. All the forces in play before September 11 have now been intensified. Beyond the sectors most directly affected—hotels, restaurants, airlines, insurance—consumers are deferring optional purchases, triggering a cycle of wider layoffs and further cuts in spending and investing. And today's plunging stock market produces not just paper losses. For the 401(k) generation, who bet their retirement income on rising stock prices, these losses to consumption are genuine.

This could also be the rare war economy with little wartime stimulus. The initial federal outlay—relief for New York, a downpayment on military and antiterrorism spending, and the airline bailout—totals only \$65 billion, not much in a \$10 trillion economy.

PUBLIC HEROES. With consumers and investors both pulling back, there is one reliable tool of economic stimulus—government spending. Since the attack, government has become almost fashionable again. The airport rent-a-cops who failed America on September 11 embodied the policy of privatizing security. The investors who ignored patriotic advice not to dump stocks were doing just what free-market theory counsels—saving their own assets. But the public heroes of New York's ground zero—cops, firefighters, medics—were public employees. And those banners flying everywhere are not the flags of Microsoft or Citicorp, but Old Glory.

In a time like this we rally round the one institution that unites us as Americans, that can wage war on terrorists, repair a broken transportation system, assure our public health, and also stimulate a sagging economy. We did it in

past wars and in the New Deal, and we need to rely on government now.

In this kind of economic crisis, monetary policy can only do so much because even very low interest rates will not make anxious consumers spend or entrepreneurs invest. Even tax relief has its limits, if consumers are nervous about spending. What's left is public outlay.

As it happens, two decades of government bashing have left a number of public systems in disrepair. Hence there are plenty of worthy candidates for public outlay. Fortunately, too, the obsession with accumulating a surplus for a rainy day has left plenty of capacity for public spending. The rainy day has arrived.

PUBLIC HEALTH. Begin by repealing a trillion dollars of the tax relief scheduled to take effect for the upper tax brackets after 2004 and instead spend at least \$300 billion of that money this year and next. Beyond money for military and civil defense, Washington should increase general revenue-sharing outlays, so that hard-pressed states don't have to raise taxes in a recession. We also need a supplemental welfare outlay as well as a federal infusion to unfunded state unemployment compensation systems to finance extended benefits.

With heightened airport security delaying travel, rail should be the preferred mode for trips of under 300 miles. Amtrak has new trains. What's lacking is billions of dollars in track-upgrading to make our rail system effectively high-speed, such as Europe's and Japan's.

Another high priority is rebuilding America's public health system, which has been left to deteriorate to a dangerous level of preparedness. And while we are protecting citizens against bio-terror, we might as well inoculate all kids against childhood diseases.

During World War II, we had surtaxes, not tax cuts. In this very different national mobilization, if we do tax cuts at all they should be in the form of temporary payroll tax relief. That puts relief where it's needed and stimulates hiring.

Few people in official Washington are talking this talk—yet. Both the 50-member House Progressive Caucus and the Economic Policy Institute have called for \$200 billion to \$300 billion in emergency spending for unemployment, infrastructure, health benefits, and tax rebates. Business groups are also lining up, but we need to distinguish investment from bailout. The economy needs a big spending stimulus now. The longer we wait, the deeper will be the hole.

Robert Kuttner is co-editor of *The American Prospect* and author of *Everything for Sale*.



LEGAL UPDATE

What's Your Gameplan for Privacy Legislation?

Figuring your way around and through privacy legislation can be as difficult as finding a replacement for Jerry Rice. The unabated selling of consumer databases has quickly reached a fourth-and-ten situation on every state like California, legislation is looming that may include a ruling that consumers "opt in" to data—opposed to accepting the opportunity to "opt out." A number of privacy-related bills are now pending before Congress, as states look to adopt even more restrictive laws, and untold numbers of nationwide lawsuits are surfacing to remedy privacy violations.

Setting Expectations

Accepting it. For years, companies have gathered extensive personal information about their consumers and hawked it on the streets like 49ers game-day programs. But that does not match consumer expectations, nor has it for some time.

Consumers, not to mention federal and state courts, expect companies to guard their personal information like a running back clutching the ball with both arms.

And as technology surges and businesses seek new ways to gather, utilize and profit from private information, the business world will see an uptick in new laws, judicial opinions and regulations which restrict and regulate the use of demographic and personal information. Litigation to enforce these controls will roll in like the fog on a winter day.

In fact, as consumers begin to fully realize the amount of personal and private information exacted from common interactive marketing tools, and comprehend the display and access of it in databases and on-line, they will instigate more and more litigation.

Policy Making Made Hard

At the same time, private attorneys and public interest groups are stepping up efforts to bring litigation asserting new theories for recovery.

Both e-business and traditional business companies must keep these privacy issues in their current playbooks just to comply with the existing privacy laws and avoid being sacked by public misconceptions and bad publicity which could easily damage their reputations, alienate customers and invite litigation.

For example, when an e-Biz privacy policy is drafted in overly broad language, it can later come back to bite its owner, who may want to sell or transfer its valuable database of personal consumer information.

Businesses must comply with everchanging legislation. Now legislation is pending in many states — including California — imposing even more restrictive constraints.

Sorting out the gathering and use of private consumer information requires businesses to employ its company managers, marketers, advertisers, in-house counsel, transactional counsel and litigation counsel — all who may have a hand in designing the policy if its going to be effective.

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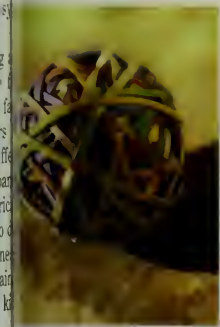
More than 25 attorneys and 10 research analysts are based in the San Francisco office of Shook, Hardy & Bacon. Opened in 1998 as a result of client need for representation in the area, the

majority of the attorneys in the San Francisco office are female litigators.

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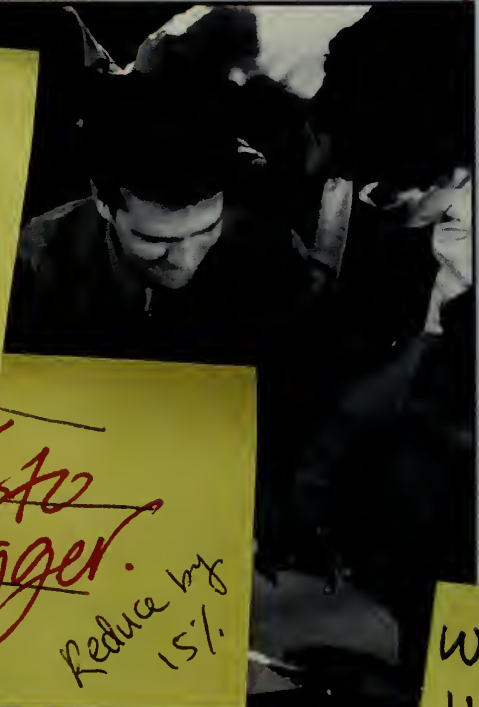
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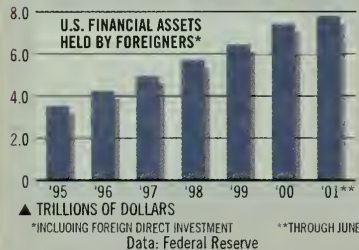
A WEAK DOLLAR HURTS GLOBALLY

The specter of a deflationary spiral

The September 11 attacks and the looming recession in the U.S. have spurred fears that foreign investors may start pulling money out of the country. That could drive the dollar down, impairing a U.S. recovery, as companies find it harder to raise capital overseas.

But the dollar's central role in the

SOARING FOREIGN EXPOSURE TO A FALLING DOLLAR



world financial system means that a plunge could make life much worse for other nations, notes David A. Levy, vice-chairman of the Jerome Levy Economics Institute at Bard College. One reason, of course, is that big exporters such as Japan and Germany would find it harder to sell to American consumers and businesses, since a falling dollar means higher prices for imports.

Beyond that, foreign investors would be hit by a reverse "wealth effect" if the dollar declined. In the second half of the 1990s, such investors, lured by America's rapid growth and high equity returns, gobbled up trillions in dollar-denominated debt and equity. From yearend 1995 to June, 2001, the value of foreign-held assets in the U.S. rose from \$3.5 trillion to \$7.8 trillion. Foreign direct investment in U.S. companies more than doubled, to nearly \$1.5 trillion.

A sharp plunge in the dollar would dramatically reduce the value of these assets, reducing the wealth of foreign investors. That could drag down consumption and investment overseas, and damage financial systems in countries that had grown accustomed to using the dollar as a safe currency. A falling dollar would be a major deflationary influence on the world economy, notes Levy. "The weaker the dollar, the more

damage it does to the global economy."

It's not just holdings of U.S. assets that are at risk. Because of the strength of the dollar and of the U.S. economy in the 1990s, it became commonplace for even foreign companies to issue debt denominated in dollars. Dollar-denominated bonds now account for 51% of all international bonds outstanding—that is, bonds issued outside the home country or home currency of the borrower. That's up from 34% in 1995. If the dollar falls, those bonds would all become much less valuable to the investors holding them—and much more of a problem for the global financial system.

By James Mehning

NATURAL GAS MAY GET A LIFT

The case for tax credits is boosted

Few would disagree that the U.S. needs to reduce its reliance on overseas supplies of energy. The question is how. Now, a new study from the Energy Dept.'s Energy Information Administration offers evidence suggesting that tax incentives can help boost domestic production of energy.

The report, released on Sept. 27, analyzed the long-term impact of tax credits enacted in 1980 for "nonconventional" fuel production, which includes extracting oil from shale and natural gas from coal seams. The net impact of the credit is to significantly boost the effective price that companies receive for their production.

Surprisingly, the report finds that such tax credits were a key factor in a jump in domestic natural-gas production in the 1990s. From 1990 to 1999, the increase in natural gas produced from coal seams—a technique covered by the credit—equaled 57% of the total growth in U.S. natural-gas production. Moreover, major energy companies that took advantage of tax credits increased natural-gas output by 26% from 1990 to 1999. Companies that didn't get tax credits saw natural-gas output fall 14%.

Obviously, other factors besides tax credits helped push up natural-gas production in the 1990s, including rising natural gas prices. Nevertheless, with the Senate slated to take up energy legislation by the end of 2001 and the tax breaks due to expire a year later, the report gives ammunition to those who support the use of tax incentives to boost domestic energy production.

By Laura Cohn

FEWER JOBS IN THE EURO ZONE

Hard times may last a year or more

Bad news for European policymakers: Joblessness in the 12-nation euro zone has started climbing. After falling to 8.3% in June, July, and August—its lowest level in two decades—economists now expect the unemployment rate to rise for at least the next year. Sharda Dean, euro zone economist at Merrill Lynch & Co. in London, predicts the figure will reach 8.9% by the third quarter of 2002.

That's a smaller jump in joblessness than is expected in the U.S., where even the most optimistic forecasts predict the unemployment rate will jump a percentage point or more in the next year. Part of the difference is that the slowdown is expected to be less severe in Europe.

Equally important, unemployment is expected to rise more slowly in Europe because tight regulations make the labor market more rigid. France, Europe's second-biggest economy, created jobs at a brisk pace in the first half largely because the introduction of the 35-hour workweek forced even reluctant companies to hire more workers. Meanwhile, laying off unwanted staff is difficult because employers have to justify the cuts and offer generous severance.

Still, unemployment, already high by U.S. standards, is rising even in countries with regulated labor markets. French joblessness ticked up in August for the third straight month, after hitting an all-year low in May. And unemployment is up in Germany since first quarter 2001 and now stands at 9.3%.

With elections due in France and Germany next year, pressure is mounting on policymakers to reverse the jobless tide. Business leaders such as Rolf Breuer, the head of Germany's Deutsche Bank, say the long-term solution to Europe's high unemployment rate is to loosen regulations. But politicians worrying that liberalization would add to unemployment, little action seems likely anytime soon.

By David Fairla

FRANCE'S RISING JOBLESS RATE



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THE DATA WILL BE GRIM— BUT GIVE THE FED A CHANCE

This cycle is different from the past. But rate cuts will still work

U.S. ECONOMY

An old fear about monetary policy is cropping up. The concern arose during the 1990-91 recession and in the even more severe 1981-82 slump before that: This cycle is different from the past, the theory goes, so lower interest rates will not revive growth. The Federal Reserve is, in effect, pushing on a string.

The argument's current version goes like this: The Fed undertook the most aggressive easing in the postwar era, but it hasn't worked, because the economy's Achilles' heel is overinvestment by businesses. Overcapacity is a supply problem not conducive to demand stimulus like lower borrowing costs. Moreover, the post-September 11 drop in stock prices

and higher corporate bond yields have retightened financial conditions and offset the Fed's earlier stimulus. In short, the U.S. faces a Japanese-style crisis of near-free money that no one wants to borrow. True, this business downturn is unlike any other. The unprecedented uncertainty among businesses, consumers, and investors makes it likely that any progress toward recovery ground to a halt in the third quarter. The economy will most likely contract in the fourth quarter, and the growth outlook for 2002 is murky at best. The immediate impact of the September 11 shock will make the data in coming weeks look terrible. This bad news will stoke criticism of the Fed, even though they have responded to the tragedy forcefully by flooding the financial system with liquidity and by cutting the federal funds rate by a half-point on both Sept. 17 and Oct. 2 (chart). At 2.5%, the funds rate is now the lowest in almost four decades.

QUESTIONS ABOUT the efficacy of Fed policy proved to be overblown in the two previous recessions, and that will be the case again this time. First of all, monetary policy takes time to work. The primary impact of lower rates is not directly on demand. Lower rates trigger a reliquification process in which consumers and businesses use cheaper borrowing rates to pay off debts and shore up their balance sheets.

Second, the latest data on industrial activity and consumer spending suggest that the economy was find-

ing a bottom in late August and early September, and that previous rate cuts were beginning to work. Lastly, Japan's problems are structural and more severe than those in the U.S. The bottom line: Monetary policy will work—and it will get help from fiscal policy.

Here's why. Fed policy acts with a lag, and the data were already showing that the rate cuts of earlier this year were directly responsible for companies and consumers getting their finances into better shape prior to September. Corporations had issued a record volume of bonds this year as long-term financing rates fell. Cash flow of nonfinancial companies actually rose 9% in the second quarter, according to an analysis of recent Fed data by economists at J.P. Morgan Chase & Co.

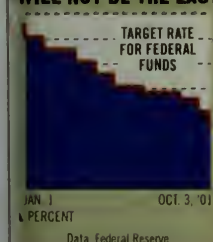
Corporate belt-tightening was paying off. Commerce Dept. data show that the erosion of profits has become progressively smaller since the end of 2000. Earnings of nonfinancial companies fell only \$10 billion in the second quarter from the first-quarter level, compared to a \$63 billion decline in the fourth quarter.

Homeowners, meanwhile, are taking advantage of lower rates to refinance their mortgages, the biggest debt owed by most households. Consumers are either tapping their home's equity for extra cash or lowering their monthly mortgage payments. Plus, consumers are using their tax rebates to save more or pay down existing debts (chart). That has put consumers in a better position to keep spending.

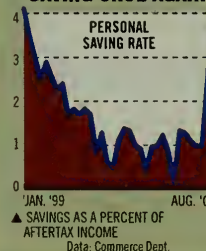
IN FACT, THE FED'S RATE CUTS were producing results. The pre-September 11 data show that the economy, while still weak, was looking firmer in key areas, making it less vulnerable to the impact of last month's shock. Real consumer spending, as measured in the GDP data, was on a track to grow at an annual rate of 3% or more in the third quarter, prior to the attacks. That would have been the best consumer showing in a year. September car sales, while down from August, held up far better than anyone had expected.

The factory sector was also showing signs of stabilizing, at least outside of tech equipment. August capital-goods orders posted their first increase in five months. In September, the purchasing managers' index

THE NINTH RATE CUT WILL NOT BE THE LAST



CONSUMERS ARE SAVING ONCE AGAIN



of industrial activity dipped to 47%, from 47.9% in August, but remained above its average of the first half (chart). For the second month in a row, the purchasers said that production increased and orders rose, a sharp departure from previous months. Although some survey responses were received before September 11, the majority were received afterward. Plus, the purchasing managers' September index of nonmanufacturing activity, mostly services, rose sharply. All of this shows how Fed policy works with long lags that vary from business cycle to business cycle.

THAT LEAVES THE FINAL ARGUMENT of the string-pushing theory: that the U.S. has slipped into a Japanese-style liquidity trap. But, again, this holds no water.

Japan has long-run structural problems that have caused a breakdown of the investment and growth process. A centrally planned and heavily regulated economy makes Japan less efficient and less responsive to policy. In contrast, long-run growth prospects in the U.S., fueled by technological progress and faster productivity, remain bright. The decline of government regulation has spurred risk-taking and innovation in the U.S. and has streamlined distribution systems.

Equally important is the fact that Japan's banking system is in a shambles: Banks are already awash in nonperforming loans, and there is no incentive to make new loans. U.S. banks are in excellent shape com-

pared with both their Japanese counterparts and their condition in the 1990-91 recession, when the savings and loan crisis did threaten the banking system. That crisis was one of the "headwinds," as Fed Chairman Alan Greenspan put it back then, that the Fed had to fight. But the Fed cut its overnight loan rate from 6% to 3% and banks were relieved, and the economy sailed on.

The headwinds are different this time, but they are no less amenable to Fed action. After the Oct. 2 cut, the inflation-adjusted funds rate is down to about zero, which is not unusual in a recession or immediately following. The Fed kept the real funds rate negative for almost two years, in 1992 and 1993, in order to assure a recovery. This time around, policymakers seem likely to cut the fed funds target to at least 2% in coming months, meaning that the real rate will be negative for the rest of the year.

Absent the September 11 tragedy, the action of the Fed in early 2001 would now be more evident. The naysayers notwithstanding, the massive amount of monetary stimulus already in place will pull this economy out of its contraction. But even the Fed could not protect the economy from such a horrible shock

SOME GOOD NEWS FROM U.S. PURCHASERS



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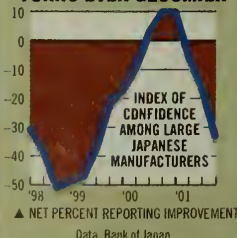
Japan was already in recession before September. Now, a U.S. contraction means that there will be no quick recovery for the world's second-largest economy.

That was the reading from the latest Tankan survey released by the Bank of Japan. The sentiment index of large manufacturers fell to -33 in the third quarter, from -16 in the second and 10 at the end of 2000 (chart). The 43-point slide was the steepest three-quarter drop since

of the replies were received after the September 11 attack.)

Japan slipped back into recession in the spring. Real gross domestic product fell 0.8% in the second quarter. The monthly data

BUSINESS SENTIMENT TURNS EVEN GLOOMIER



1992. The results for nonmanufacturers as well as small businesses were equally distressing. Companies are downbeat about profits, capital spending, and employment prospects. (The BOJ said that 70%

indicate that real GDP fell by at least that amount in the third quarter. Housing starts have been weak. Industrial output fell 2.8% in July and rebounded by only 0.8% in August. Factory orders and sales are trending lower, and real house-

hold spending fell 1.3% in August. The consumer sector has been hit hard because labor markets continue to collapse. Jobs rose by 50,000 in August, but the bulk of the positions were part-time. The

unemployment rate stayed at a record 5% in August.

Policymakers had hoped that a pickup in U.S. economic growth would increase the demand for Japanese goods. That hope has all but evaporated now that the U.S. is sliding into recession.

Prime Minister Junichiro Koizumi has begun the difficult process of bank reform, a prerequisite for the economy's long-term health. But for the short run, the U.S. downturn means that Tokyo will face an even tougher time turning around the Japanese economy. The BOJ has cut interest rates to near zero, and Koizumi has already pledged to cut public-work programs by 10% in order to keep Japan's public debt below 120% of its GDP. With little policy stimulus coming, Japan's recession could drag on well into 2002.

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TOUGH TIMES: HOW LONG?

Fiscal and monetary stimulus may spark a sharp upturn by next spring or summer

No matter how much things change, human nature stays the same. When business is booming, people assume the good times will never stop. But that works in reverse, too. When the economy is going down, many find it hard to see what will make things turn around again.

That's the position the U.S. is in today. Even before September 11, the economy was trapped in a long, slow slide. Growth had slowed to a crawl. The Standard & Poor's 500 had fallen 13% since the start of the summer. Manufacturing was contracting, unemployment was rising, and orders for tech gear were falling at a 28% annual rate.

Now, after the attacks, the immediate future has gone from gray to black. From retail sales to advertising to technology, there's little cheery news. "The short-term outlook is not good," says R. Glenn Hubbard, head of the Council of Economic Advisers. He thinks the "probability" is that the U.S. fell into recession in the second half of 2001. His predecessor at the CEA, Martin N. Bailey, now a senior fellow at the Institute for International Economics, says "it's possible" that the economy could contract as fast as it did during the second quarter of 1980, when gross domestic product fell at an annual rate of almost 10%.

"CAPITAL V." Now the question is simple: How long will tough times last? As companies announce layoffs and shutdowns, many fear that unemployment could undercut consumer spending, forc-

ing more layoffs and sending the U.S. economy into a long downward spiral.

But unless there's another major terrorist attack at home or a series of military defeats overseas, that's not the most likely scenario. Instead, the combination of enormous fiscal and monetary stimulus, plus a stable financial system, could produce a sharp recovery starting sometime in the spring or summer of 2002. "We were in an L [shaped recession] before this," says Charles L. Hill, director of research at Thomson Financial/First Call. "Now, we are back to a V, except that it is a capital V." By that he

means the economy will probably suffer a rapid downturn, followed by an equally rapid upturn.

This positive view is shared by some in business. That even includes some executives in the beleaguered auto industry, which saw sales fall by almost 9% in September, according to Autodata Corp., a Woodcliff Lake (N.J.) researcher. "I think we can expect two very difficult quarters," says Tom Purves, CEO of BMW (U.S.) Holding Corp. But, he adds, "my crystal ball is fairly optimistic for spring and late summer next year."

Why such optimism? First, the latest Federal Reserve rate cut, announced on Oct. 2, drops the federal funds rate on overnight lending to banks to 2.5%. That's below the core rate of inflation, now running at 2.6%. As a result, short-term borrowing is effectively free, lowering the cost of funds for lenders and stimulating borrowing. The last time this happened was in early 1992—precisely when growth really started to

THE ECONOMIC AFTERSHOCK



accelerate after the last recession.

At the same time, a combination of higher defense spending and recovery aid is reversing a decade of a falling government share of the economy. The fiscal stimulus—which could exceed \$100 billion—will boost demand, add jobs, and partially offset the drag from layoffs and cutbacks in business investment. “We are about to apply more stimulus than I can ever remember being pumped into the economy,” says Bruce Steinberg, chief economist of Merrill Lynch & Co. He’s forecasting 4.7% growth for the last three quarters of 2002.

One problem that might upset this rosy scenario would be a distressed financial system, which would make interest-rate cuts less effective. The danger is that banks and other lenders could be paralyzed by the combination of a depressed stock market, rising defaults, and increased uncertainty—causing a sharp contraction in lending and borrowing, even if interest rates fell. In many ways, that’s what happened in Japan in the 1990s.

But the U.S. is not Japan. There, the banks have been weighed down by an enormous overhang of bad loans, leaving them unwilling and unable to lend no matter how low rates got. Indeed, the U.S. financial system seems to be surprisingly healthy. Banks are well-capitalized, with the top 30 institutions having \$40 billion in excess capital as of the middle of 2001, according to Andrew Collins, an analyst at U.S. Bancorp Piper Jaffray. Moreover, the Fed, by starting to pump money into the economy early in 2001, enabled the financial system to absorb the tech crash without much ill effect. Although initial public offerings and venture capital fell, corporate borrowing was still going strong before the attacks.

DEEP VALLEY. Unlike the Japanese, U.S. consumers still appear responsive to lower interest rates, especially when they have the chance to turn the equity in their homes into cash or reduce monthly loan payments. Since the beginning of

September, refinancing applications have risen by 51%, as 30-year mortgage rates fell by 20 basis points, to an average of 6.5%, their lowest levels since October, 1998. “The worst economic contractions have always been associated with major financial instability,” says Frederic Mishkin, a professor at the Columbia University School of Business and a former research director at the New York Federal Reserve. “There’s no evidence that I’ve seen of any stress on the financial system.”

None of this, however, will stop a deep downturn in the fourth quarter. Forecasters willingly admit that they have no idea just how bad it will be. “We’re going into a valley,” says Merrill Lynch’s Steinberg, “and we don’t know how deep the valley will be.” His best guess is that the economy will contract at a 1% rate in the third and fourth quarters.

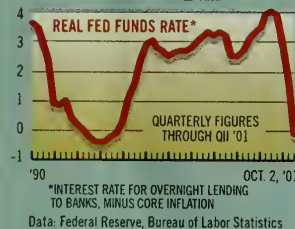
Every part of the economy will be hit. Consumer spending, exempt so far from the general malaise, will fall at a 2.2% rate in the fourth quarter as confidence stays low, says David Wyss, chief economist at Standard & Poor’s. And new-home sales are also expected to fall—from a seasonally-adjusted rate of about 900,000 in August to as low as 790,000 in

December—says David F. Seiders, chief economist at the National Association of Home Builders. He estimates housing’s overall portion of GDP will contract 3% in the third quarter and 5% in the fourth quarter. “We will no longer be a support to the economy,” he concedes. The same is true for commercial real estate, notes Sam Zell, chairman of Equity Office Properties Trust, the nation’s largest publicly traded real estate investment trust: “Right now, there is almost nothing happening.”

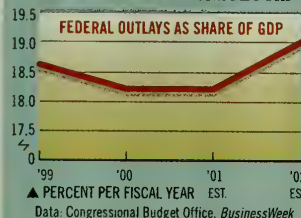
And there’s certainly no immediate sign of a revival in technology spending. In a post-attack poll of 198 senior executives, *CIO* magazine found that they expect info-tech budgets to rise by only 3.7% in the next 12 months, down from a

THE FORCES FOR RECOVERY

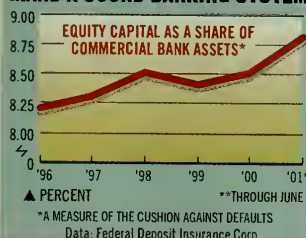
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...AND A SOUND BANKING SYSTEM



7.2% prediction in August. And when it comes to venture capital, "we were in a big chill before 9/11," says C. Richard Kramlich, a founding partner at New Enterprise Associates, one of the country's largest venture funds. "Now, we're in a deep freeze."

Moreover, another big terrorist attack would almost certainly poison the midterm economic outlook. It would destroy any tentative revival of confidence and spending. Such an attack, "would slow things down dramatically," says Jed Connelly, senior vice-president at Nissan North America Inc. "We'd go right back to square one, right where we were after the first one."

Some business leaders, to be sure, are more downbeat about prospects for a quick recovery even if there's no new attack. "I don't know whether it will be another quarter or another three quarters, but we have to be ready for at least another year [of tough times]," says W. James McNerney Jr., chairman and chief executive of 3M Corp, which is facing a continued drag from its unit that supplies telecom companies.

PLENTY OF MAGIC. And certainly there's a danger that a recovery could be stalled by a sharper-than-expected rise in unemployment. That could drag down the housing market and consumer spending. Already, credit-card delinquencies are at record levels. If unemployment hits 7%, bankruptcy rates could rise by 20% in 2001 and by an additional 20% to 30% in 2002, to \$1.7 million, estimates Kenneth A. Posner, an analyst at Morgan Stanley Dean Witter & Co. "The thing to worry about most is consumer defaults," says David O. Beim, a finance professor at Columbia University. "That's the thing most likely to accelerate us from a modest to a more significant recession."

Still, there may be enough monetary and fiscal stimulus in the pipeline to keep that from happening. Moreover, there's plenty of evidence that lower rates can work their magic. For example, potential car buyers clearly responded when General Motors, Ford, and DaimlerChrysler introduced 0% financing deals at the end

HOW A V-SHAPED REBOUND MIGHT MATERIALIZE

AUTOS After several poor quarters, auto makers expect lower interest rates to bring buyers back to the showrooms

COMMERCIAL CONSTRUCTION It's frozen now, but low interest rates and the need for companies to rethink location strategy may push construction next year

CONSUMER SPENDING Although rising joblessness and uncertainty could dampen consumers' exuberance this year, the refinance boom and fiscal stimulus will spark growth by the spring of next year

HOUSING Fed rate cuts mean that getting a mortgage should remain cheap and easy, so housing could get a bounce after consumer confidence returns

TECHNOLOGY Most tech sectors should bottom out by second quarter, 2002—but a strong boom is not anticipated

VENTURE CAPITAL

Money should start flowing into new businesses by early next year, but a real revival of VC funding depends on when the stock market starts rising

of September. GM sales, which had declined about 20% after the attacks, rose 22% in the final week of the month—after the company introduced its low-rate promotions to jolt people back into spending. Even though auto sales are still expected to fall by 5% to 10% in 2002 as the economy slows, the Fed's latest rate cut will lower the cost of auto loans and leases. It also will make it less expensive for carmakers to offer such sweet financing deals again in the future, if needed.

Surprisingly, the sagging technology sector may also be more responsive to interest-rate cuts than people realize. Tech growth started to slow only in mid-2000—about a year after the Fed began raising rates. The link works in the other direction, too, notes G. Dan Hutcheson, an analyst at VLSI Research Inc., a market researcher in San Jose, Calif. "Historically, there's a year lag between interest-rate cuts and their effect on the chip industry." He's predicting an upturn in the semiconductor industry in the second half of 2002. Another favorable sign: On Oct. 3, IBM announced lower-financing rates on some servers and products.



DETROIT: Start your engines?

Some analysts believe that in the long term, the events of September 11 could stimulate demand for some kinds of technology spending, as companies focus on boosting the reliability of their networks. "We've raised the priority [for enterprise computing] level once again," says Laura Conigliaro, an analyst at Goldman, Sachs & Co.

In addition, many venture capitalists expect the venture market to hit bottom in the fourth quarter and stabilize early in 2002 as inventory backlogs get worked off. Says Tracy Lefteroff, global managing partner for private equity and venture capital at PrivateerhouseCooper, "People in the venture industry just



TECH: No strong boom foreseen

want to get this year behind them. They think they'll start getting back in."

Homebuilding may follow the same pattern, with a slowdown followed by recovery during the second quarter. "Historical evidence points to the fact that there are always aftershocks in the wake of tragedy, but that these effects are typically temporary," explains Home CEO Bruce Karatz. He adds that business has returned to near-normal levels at KB Home as consumers try to get back to normal.

That's a claim that a lot of other businesses would like to make. Economic forecasting is never a science, and uncertainty at times like these is even greater than ever. But there's a good chance that the middle of 2002 will far brighter than today.

By Michael J. Mandel, with Heather Timmons, in New York; Stephanie Anderson Forest in Dallas; Michael Aronson in Chicago; Joann Muller in Detroit; Linda Himmelstein in San Mateo; and bureau reports



HOMES: Going up

By Rich Miller

WHY THE FED SHOULD STICK TO RATE-CUTTING

To most people, the Federal Reserve looks to be pulling out all the stops in its drive to repel a recession. In the three weeks following the terrorist strikes, it cut its target for short-term interest rates twice, to 2½%. The latest reduction, on Oct. 2, was the ninth this year and left rates at their lowest level in four decades. And the Fed has promised more to come.

But as far as a small band of supply-siders is concerned, that's not nearly enough. They contend that the Fed is behind the curve in fighting the deflationary forces rippling through the economy. And to make matters worse, they charge that the Fed has actually tightened the monetary screws recently, despite its latest two rate cuts.

How can that be? Well, in the immediate aftermath of the crisis, the Fed pumped tens of billions of dollars into the economy by buying bonds from securities dealers and by lending money to banks. It was an all-out effort to keep the financial system running and make sure that banks and brokers had enough money to keep dealing. As a result, the banks' excess reserves—the money they hold over and above what is required by the regulators—soared. From a daily average of just \$1.5 billion before the attack, excess reserves grew 26-fold, to \$39 billion, in the two weeks ended Sept. 19. The Fed even let the overnight rate that banks charge each other fall to close to zero at one point, well below its then-stated target of 3%.

MOPPING UP. But as the financial markets returned to some semblance of normality, the Fed gradually began mopping up much of that excess money. Bank reserves have now fallen back significantly, and in the process, short-term interest rates have moved

back up to their intended target level. That has the supply-siders, led by economist Lawrence A. Kudlow and former GOP Vice-Presidential hopeful Jack Kemp, howling in disbelief. They charge that the Fed is robbing the economy of the very liquidity it desperately needs right now. "The Federal Reserve has still failed to come to grips with the fundamental cause of the economic slump: namely, a lack of liquidity," says former Reagan Administration official Kudlow. He was one of five economists who recently met Vice-President Dick Cheney to discuss how to rescue the economy.

As far as this cohort of supply-siders is concerned, the Fed is making a mistake by targeting interest rates.

Instead, it should continue to pump billions of dollars in excess reserves into the system and let the market determine where rates end up. By targeting bank reserves rather

than interest rates, the argument goes, the Fed would provide the markets and the economy with the liquidity they need.

The supply-siders' criticism of Fed interest-rate targeting harks back to that made by monetarists in the

1970s. But rather than targeting money-supply growth, today's Fed critics prefer to judge monetary policy by

looking at financial and commodity market indicators. And they don't like what they see. Commodity prices are continuing to fall, despite the Fed's repeated rate cuts. And the government debt market, too, is signaling that the Fed has more cutting to do; the yield on the 91-day Treasury bill now trades a quarterpoint below the central bank's 2¼% target.

BIG ADJUSTMENT. There's no doubt that a case can be made that the Fed needs to ease credit further. But the risk is that the radical measures advocated by the supply-siders could end up doing more harm than good. By shifting the Fed's focus, they would introduce a lot more uncertainty into the economy at a time when consumers, companies, and investors are already pulling back in the face of an unclear outlook. "It would take months for the markets to adjust," says consultant Louis Crandall of R.H. Wrightson & Associates.

What's more, there's a real danger that such a sweeping shift could eventually reignite inflation, which would spook the bond market. If investors thought that the Fed was shifting to a policy of pumping money willy-nilly into the system, they'd dump bonds, sending long-term interest rates on everything from home mortgages to corporate debt soaring.

That very real risk hardly seems worth taking to gain the questionable benefits of dulling the Fed's razor-like focus on rates.

Miller covers the Fed from Washington.

LIQUIDITY, ANYONE?



THE ECONOMY

CORPORATE AMERICA BRACES FOR THE SHAKEOUT

Just ahead, a wave of consolidations—plus more layoffs and a burst of bankruptcies

Whatever happened to “get big fast”? During the 1990s, U.S. companies were responsible for one of the biggest capital-spending booms in history. Executives raced each other for what they bravely called “first-mover advantage,” expanding far beyond what their current demand would justify. It amounted to a huge leap of faith: If you build it, customers will come.

As we now know, that was misjudgment on a massive scale. The expansion was premised on the expectation of economic growth of 4% or more as far as the eye could see. When growth slowed in 2000 and the first half of 2001, it started becoming clear that vast overcapacity existed in everything from airlines and retailing to technology and telecom.

U.S. factory capacity utilization stood at just 76% in August—the lowest level since July, 1983, when the U.S. was recovering from the devastating recession of 1981-82. Although companies began to cut back this year, many avoided drastic retrenchment, hoping the economy would soon recover.

Now companies are throwing in the towel. In the aftermath of September 11, consolidation is accelerating from a trot to a gallop. Companies are abruptly withdrawing from unprofitable lines of business, cutting workers, selling out to rivals, and in the last resort, going out of business. Says Robert J. Barbera, chief economist at Hoenig & Co.: “There was an enormous desire to hold their breath...and then feel very clever for not having fired or cut into capacity.” Now, says Barbera, “we are going to



get a lot of capitulation from companies.”

Top on the list are troubled airlines and the rest of the travel industry. But they've got plenty of company. The tech and telecom sectors, which led the investment boom, are also due for massive consolidation. So is the fragmented health-care industry and the overbuilt retail sector. And while other countries have been slower to restructure, consolidation will be a worldwide phenomenon.

On Oct. 2, for instance, Swissair, once a great blue-chip airline, grounded its fleet and filed for protection from creditors. The Swiss government pledged loans to keep it aloft until Oct. 28.

Few will escape because the September 11 attacks gave a fresh blow to an already weakened economy. At the same time, they have provided cover for cutbacks that would have seemed

too harsh before, even if they made economic sense. Moreover, the much tougher times may persuade regulators to approve mergers they might previously have questioned, provided

they can be convinced that acquisition targets were on the verge of closing anyway. Says Federal Trade Commission Chairman Timothy J. Muris: “It possible...a merger can help efficiency and in that sense help consumers.”

“MORE EFFICIENT.” For people throw out of work at a time when jobs are scarce, consolidation is nothing but bad news. Many economists expect the unemployment rate to surpass 6% within a few months, up from 4.9% in August and 3.9% last fall. Typical is battered

THE LAST PAYCHECK: Midway Airline workers in Durham, N.C., wait to turn in their I.D.s. Midway shut down on Sept. 12

THE ECONOMIC AFTERSHOCK

While the weak get weaker, the strong will use their healthy balance sheets to snap up rivals or expand

ecom gearmaker Nortel Networks Corp., which said on Oct. 2 that it would shed 20,000 jobs on top of the 30,000 it already announced this year. But for the economy as a whole, the elimination of excess capacity is a necessary prelude to economic recovery. The people and money that are tied up in overbuilt businesses—Web hosting,

say it could prop up weak carriers. As if to confirm their fears, Midway Airlines Corp., which is in bankruptcy and stopped flying on Sept. 12, is now trying to get its planes back in the air with its share of bailout money. Long-struggling US Airways Group Inc. is another candidate for liquidation or sale, though UAL Corp.—rejected once on antitrust

maker that filed for Chapter 11 on Oct. 1, was burdened by asbestos lawsuits. Renaissance Cruises in Fort Lauderdale, Fla., announced Sept. 25 that it was filing for Chapter 11. One of the weakest players in the industry, it cut short cruises in the Mediterranean and South Pacific and flew home 2,400 passengers.

As in any slowdown, it helps to have cash. Industry leaders will buy weaker rivals, or invest to keep the heat on struggling rivals through the downturn. On Oct. 2, Wal-Mart Stores Inc. announced its biggest expansion, saying it will open as many as 325 stores next year and move or enlarge 115. General Electric Co. and Tyco International Ltd. are on the acquisition trail. These are good times for contract manufacturers, too. San Jose (Calif.)-based Flextronics Inc. is getting work from companies like Xerox Corp. and Hewlett-Packard Co. that are closing factories.

DEALS ON HOLD. So far, consolidation through mergers has yet to kick in. The market turmoil since September 11 has put new deals on hold and upset pending ones. An 18% fall in the stock of

the General Motors Corp. unit that operates the DirecTV satellite service has jeopardized an acquisition bid by Rupert Murdoch. The News Corp. CEO now wants to reduce the \$6 billion cash payment GM had demanded. "We need to go through a sorting-out period," says Howard B. Schiller, co-head of Goldman, Sachs & Co.'s M&A practice in the Americas.

Still, some companies are so weakened that their deals can't wait. After four years of trying to rebuild AT&T, CEO C. Michael Armstrong is trying to negotiate a "merger of equals" with BellSouth Corp., the Atlanta-based Baby Bell, even as he faces a liquidity problem (page 52). WorldCom Inc. is another weakened long-distance player in need of a strong partner.

The hard-hit tech industry will see downsizing of its own. In 1999, there were about 300 public software companies, vs. about 130 today. And only half that many will be around in two years, predicts Goldman Sachs analyst Thomas P. Berquist. Most midsize, public companies will die, not be bought, software executives say. Oracle CEO Lawrence J. Ellison says "it's not worth it" to take on the rivals' unhappy customers.

The personal computer industry is

grounds—is unlikely to bid for it again.

Across the country, companies are halting projects and dropping product lines. Mandalay Resort Group has stopped work on a \$280 million convention facility in Las Vegas. Condé Nast Publications Inc. said on Oct. 1 that it's saying au revoir to 66-year-old *Mademoiselle* magazine. A week earlier, General Motors Corp. said it won't



SCALING BACK

Companies are taking dramatic steps to adjust to the economic slowdown.

RETRENCHMENT Unprofitable or low-growth operations are the first to go. Condé Nast is closing *Mademoiselle* magazine, while General Motors is stopping production of the Camaro and Firebird.

LAYOFFS Everyone, from airlines and auto makers to PC makers and other tech companies, is slashing jobs to get costs down. The unemployment rate could peak as high as 7%.

BANKRUPTCIES Even before Sept. 11, Chapter 11 filings were running at a record pace. Companies that resorted to high-yield bonds in the late 1990s have been especially hard hit. Industries most at risk: telecom and retail.

MERGERS AND ACQUISITIONS Dealmaking has slowed drastically, but a wave of deals will hit industries across-the-board as those with deep pockets snap up financially weak rivals.

example—can be redeployed in new companies and markets that need financing and skilled workers. "We're making companies more efficient," says Martin D. Sass, CEO of Resurgence Asset Management, a New York-based "future" firm that gets control of failing companies by buying their distressed stock and restructuring them.

For suddenly weaker companies, more mergers are likely. That's especially so in the airline industry, though some critics of the \$15 billion U.S. airline bailout

Where cutbacks aren't enough, there's bankruptcy court. Already this year, bankruptcies ran at a record pace, according to BankruptcyData.Com, a unit of New Generation Research Inc. Some 173 publicly traded U.S. companies had filed for protection from creditors through the end of August, nearly equal to the full-year record set in 2000. Most of the bankruptcies stemmed from excess debt and other problems exacerbated by the slowdown. Federal-Mogul Corp., for instance, the Southfield (Mich.) auto parts

make two old muscle cars, the Camaro and the Firebird.



COMMENTARY

By David Henry

PUTTING ON A GRIM NEW FACE

also ripe for paring down. But as in software, PC companies are reluctant to buy weaker competitors for fear of inheriting problems. That's one reason that Gateway Inc. and Apple Computer Inc. aren't considered immediate takeover targets. The reluctance to do deals was strengthened when executives saw the market's disdain for Hewlett-Packard's agreement to buy Compaq Computer Corp. Although the pact looks likely to go through—in part because Compaq has few other choices—the drop in HP's stock price has reduced the value of its bid to about \$17 billion from \$25 billion when it was announced on Labor Day.

TOO MANY HMOS. Well before September 11, retailers had begun to dial back on their massive overexpansion of the 1990s. Everyone from the newly formed AOL Time Warner Inc.—which announced plans to close all 130 Warner Bros. stores back in January—to trendy clothier The Limited Inc. had begun to trim stores. But those moves are paltry compared with what could now hit retailers. The next several quarters “could be the cleansing of the retail landscape,” says analyst Richard Church of Salomon Smith Barney. A weak Christmas season will lead to even more substantial scaling back of retail space. Saks Inc., for one, could be forced to sell its regional units or put itself on the block, analysts say. The company says it has no such plans. And even Kmart Corp.'s turnaround effort could be in jeopardy.

A wave of capacity-reducing mergers in industries with scads of small players will also hit. One such industry is health care, which accounts for more than 10% of GDP. Daryl Veach, a partner at Ernst & Young, estimates there are 500 to 700 health-maintenance organizations with less than 100,000 members each that are too small to survive on their own. “These companies need to achieve economies of scale,” says Leonard D. Schaeffer, CEO of WellPoint Health Networks Inc., the nation's fourth-biggest health plan.

Ultimately this purging and merging will set the stage for a healthier economy. But first, companies, communities, and workers must brace for pain and uncertainty.

By William C. Symonds in Boston and Peter Coy in New York, with Jim Kerstetter in San Mateo, Ronald Grover in Los Angeles, Robert Berner in Chicago, and bureau reports

BusinessWeek online

For stories on Europe's slowdown and Japan's banking crisis, go to the Oct. 15 issue at www.businessweek.com.

Brace yourself for what may be the ugliest quarter ever for corporate earnings. For years, companies used every trick in the book to make their results look better than they really were. Now, many will be taking the opposite tack: loading costs and charges onto their income statements in an all-out effort to make an already horrid year look even worse.

Crazy? Not a bit. The aim of the game this time around is to engineer a dramatic surge in earnings in 2002. The stakes are huge. Analysts such as Edward Keon Jr., quantitative strategist at Prudential Securities Inc., say that companies in the Standard & Poor's 500-stock index, the cream of Corporate America, could display earnings gains of 30% to 40% by this time next year.

Sadly, the September 11 terrorist attacks are making it easy for companies to massage the results they present. Of some 150 warnings of earnings shortfalls in the ensuing two weeks, nearly two-thirds cited the attack as a cause, according to Thomson Financial/First Call. “You're going to see a lot of companies use this as cover for missing their numbers,” says Tobias M. Levkovich, stock market strategist at Salomon Smith Barney.

Many of Wall Street's highly paid analysts are cheering them on. “There is a tolerance bordering on a thirst for earnings management,” says Sean Ryan, bank analyst at brokerage Fulcrum Global Partners. “As irrational as it may be, the market is likely to reward banks that ball up all of their problems and take big hits in the second half of this year.”

“OPEN SEASON.” Regulators seem helpless to stop the rot. Indeed, officials of the Financial Accounting Standards Board (FASB), which is charged with setting minimum requirements for corporate accounting, essentially threw in the towel on the issue on Sept. 28. Its Emerging Issues Task Force had struggled for two weeks to lay down rules for what

companies could classify as extraordinary costs as a result of the attack. But the group gave up, declaring that it couldn't come up with fair rules to cover the widespread and varied losses of different sorts of companies. As a result, “it is open season” on investors as companies spin their earnings any way they like, says Charles L. Hill, research director at First Call.

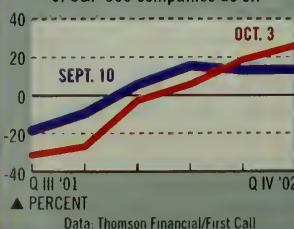
The consequence for investors is severe. Without a good fix on the true earning power of companies, they're at a loss to know whether the stock market is a buy even after the S&P 500 has fallen 20% since the start of the year.

In reality, investors would have had a hard job even if the FASB hadn't ducked the issue. Regardless of the FASB's decision, companies would be finding ways within existing rules to manage earnings down then back up later. For example, they would write down assets such as equipment, increasing this year's expense but reducing depreciation expense in the future. Or, they may delay sales arranged in December until next year. Some businesses have more scope. Ryan expects banks to write up and write off bad loans to

boost reserves for consumer loans. “That's going to be a temptation to overestimate the economic impact of the attack because it's the managements' responsibility for their own mistakes to bin Laden,” says “That clears the way for earnings in 2002. It is likely to be a wild ride. Even

BIGGER DROP, BIGGER BOUNCE

Wall Street analysts' estimates of year-over-year changes in earnings of S&P 500 companies as of:





PROFITS WILL GET WORSE BEFORE THEY GET BETTER

To make next year's results look stronger, companies may load losses into 2001 by:

SLASHING values of physical assets, which will cut depreciation charges in the future

OVERESTIMATING likely bad debts, thus boosting future profits when customers pay up

CHARGING impending restructuring costs immediately, so as to benefit if they're less than expected

DELAYING the close of sales contracts beyond yearend, to boost 2002 revenues

from the start of next year. Only when the assets lose value will they have to be written down in the future. While the change was needed, it alone will artificially boost reported earnings in 2002 by about 5% for the S&P 500, again making the rebound look stronger than it really is. Including the change, strategists estimate earnings will climb 17½% for all of 2002.

Of course, there's a risk that there will be no rebound at all. The whole two-step strategy of depressing and then inflating earnings is based on a gamble that the economy will follow the same trajectory—diving, then soaring in a V shape. But there might not be a V of any kind if there are more devastating terrorist attacks or if the Federal Reserve and the government fail to lift the economy.

Even a big improvement next year will leave earnings far short of those in 2000. Strategists estimate earnings per share of the S&P 500 in 2002 will be \$52.16, up from \$44.38 in 2001, but still well below the \$55.12 hit in 2000. Earnings won't reach 2000 levels again until 2005, says economist Steven Wieting of Salomon Smith Barney.

Logically, the uncertainty about companies' true earnings power should weigh on their stock prices over the next year or two. But from week to week, the mood of investors and traders will largely determine whether the market accepts next year's reports of gains at their face value or tries to see through the accounting games. If they feel optimistic, as they would if the counterattacks on the terrorists go well, they'll be inclined to believe in the earnings rebound—just as they accepted overblown valuations in the late-1990s bull market—and bid the market higher. So, if the outlook for a rebound holds, it should support the market in a few months. "People will look past [2001's] depressed earnings," says Levkovich.

Maybe so. But this is truly a confidence game now. If investors don't feel sure the economy is coming back, they won't buy anybody's numbers, no matter how well massaged.

Associate Editor Henry covers accounting issues.

ings manipulation starts in Wall Street strategists were their earnings estimates. On strategists were forecasting a p in third-quarter earnings going operations of S&P 500 as, nearly double the 18% dey had been expecting the day ie terrorist attacks, according Call.

G GAME. Even the strategists' numbers are just a guess their economic forecasts. investors can also look to esti-mpiled by hundreds of ana-o study individual companies. analyst estimates are still in-e or out of date. Many analysts' offices and computers in the and more are at a loss deciding ch of the earnings declines of any company they follow should be ig-exceptional. ngs guidance from companies is in quality. The financial giant p Inc. said insurance claims

would cut 10¢ a share, and the closing of the stock market 3¢, from third-quarter earnings. Auto maker Ford Motor Co. initially said its earnings would fall short of analysts' estimates because it was cutting production after parts were not delivered immediately after the September 11 attack. Later, it also blamed zero-cost customer financing that it started on Sept. 17 to jump-start sales. On neither occasion did Ford put a figure on the shortfall. Clothing retailer Men's Wearhouse Inc. announced on Oct. 3 that the "dramatic consumer reaction to the recent events" is depressing sales, and that third-quarter earnings would be half of analysts' estimates. "It is going to be tough to sort out what is valid and what isn't," says Hill.

Investors trying to value any earnings bounce next year face an added complication. Months ago, the FASB decided to end the obligatory amortization of goodwill—the premium that companies had paid for past acquisitions—

THE ADMINISTRATION

STIMULATE THE ECONOMY, SURE. THE QUESTION IS HOW

Negotiations point up big differences on key relief issues



By all accounts, the war against terrorism is beginning well on many of the fronts outlined by President Bush in his ringing address to Congress. The U.S. has assembled a broad coalition of countries pledged to isolate Islamic radical Osama bin Laden and his Taliban protectors. The Pentagon is moving a potent strike force of troops and bombers to the borders of Afghanistan. And with \$100 million in suspected terrorist finances already frozen, the Treasury Dept.'s bid to dry up bin Laden's funding is off to a respectable start.

But the most halting part of this multifaceted campaign is the battle to rev up a domestic economy rocked by September 11's terror strikes. Congress and the White House are inching closer in attempts to fashion antirecession relief. But key decisions have eluded negotiators, and talks may stretch for several more weeks. In Washington, this pace is considered sizzling. But to anxious CEOs, 30 of whom huddled with the President in lower Manhattan on Oct. 3 to plead for new tax cuts, the process of shaping a stimulus package is taking a lot longer than many think is prudent.

One reason for the drawn-out process is that George W. Bush is determined to forge a bipartisan consensus for any initiative that erases the budget surplus. Just how determined can be seen by

the protests of GOP hard-liners. They complain that Bush is tilting toward Democrats' ideas for progressive tax cuts and social spending while neglecting Republicans' calls for generous business breaks and sweeping rate reductions.

The backbench bickering is so intense that editorialists at *The Wall Street Journal*, who have until now been solidly pro-Bush, warn that a wimpy stimulus plan that neglects big cuts in marginal tax rates may leave the economy vulnerable later, à la George H.W. Bush.

White House and Hill leaders are still leery of any plan veering off into big deficits. But on Oct. 3, Bush signaled he would be willing to wade into a little red ink by accepting \$75 billion in new incentives. That's \$23 billion more than the latest projection for the fiscal 2002 surplus. CEOs who met with Bush weren't fazed, either. "Sometimes you have to have deficit spending," said Maurice R. Greenberg, chairman and CEO of insurance giant American International Group Inc. He believes it's justified to give the economy "a little shove."

Still, finding just the right formula to propel the economy forward is a complex challenge for policymakers. Any

INCH BY INCH
Pragmatism is prevailing as Bush and Congressional leaders strive for consensus

plan must reflect Democratic calls for putting fast cash in consumers' hands and aiding dislocated workers. At the same time, it must heed GOP demands to cut tax rates and give business breaks that was denied in the President's initial \$1.35 trillion tax plan. "Bipartisanship," says G. William Hoagland, GOP staff director of the Senate Budget Committee, "can be very expensive."

Here's how the negotiations are shaping up:
Bolstering Business
Conservatives feel that in an investment-lump slump, business needs special incentives to spur capital spending. But their ideas, such as a capital-gains cut and permanent reduction in corporate rates, have faded amid doubts about cost and efficacy.

Instead, negotiators are looking at liberalizing depreciation and first-year expensing of equipment, ideas that would rapidly boost cash flow. The latter enjoys the backing of key Senate Democrats, such as Finance Committee Chairman Max Baucus (Mont.) and Budget Committee Chairman Kent Conrad (D-N.D.).

Democrats are willing to buy some business cuts, but insist that the breaks phase out fast. "The last thing we should do," says Conrad, "is worsen our budget outlook with permanent tax or spending measures."

Consumer Cash Democrats are winning concessions on pleas for new "demand-side" stimulus. Talks focus on a tax rebate for poor workers who did not qualify for the first round of refund. A payroll-tax cut of 1%-2% is also on the table. As a sweetener to Republicans, Democrats may extend the payroll credit to employers, as well.

Expanding the Safety Net In return for supporting a bailout for airlines and other hard-hit businesses, Democrats won a GOP pledge for new worker assistance. Likely elements: The 26-week unemployment insurance benefit will be extended by at least 13 weeks, states will be able to tap disaster-relief funds to help the jobless, and idled workers will get subsidies to continue employment provided health insurance. Another bet: The minimum wage, currently \$5.15 per hour, could be hiked by

THE ECONOMIC AFTERSHOCK

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least a dollar. "There's a critical mass building for worker relief," says Edward Wytkind, who heads the AFL-CIO's September 11 response team.

Although this consensus-building is slower than many would like, the movement is in the right direction and the desire to keep bipartisanship going is strong. "It's important to keep the sense of unity going," says Democratic pollster

Mark Mellman. Adds Princeton University political scientist Fred I. Greenstein: "Clearly, this kind of unity has a half-life. But [Bush] is proving to be very pragmatic."

While the new mood won't last forever, it's still something to be savored. To veterans such as Senator Richard G. Lugar (R-Ind.), quibbling about stimulus details "misses the mark. All kinds

of [opposing ideas] have to be put in such a package for the sake of consensus." That's because consensus, as much as any tax credit, seems to be emerging as a key psychological element of the economic rescue drive.

By Lee Walczak and Richard Dunham, with Howard Gleckman and Alexandra Starr in Washington, and Heather Timmons in New York

THE SQUEEZE ON THE STATES JUST GOT WORSE

The reverberations from September 11 didn't take long to hit state capitals from Florida to Michigan to Hawaii. Plans for opulent new sports arenas or airport upgrades are being shoved aside as officials try to cope with rising unemployment claims, mounting Medicaid payouts, shrinking hotel-tax collections, and pension funds jeopardized by a volatile stock market. "We are now in an incredible period of uncertainty," says Scott D. Pattison, executive director of the National Association of State Budget Officers.

Even before the attacks, state worries were growing. A yearlong recession in manufacturing and a slowing services economy were threatening balance sheets. States had chopped projected revenue growth for the fiscal year, which had just begun, to an average of 2.4%—the lowest rate in a decade, according to the National Conference of State Legislatures. By the end of August, seven states were already planning to cut back on spending to balance their budgets, even though their fiscal years had only started on July 1. The culprit: plummeting income- and sales-tax receipts, combined with Medicaid spending running at 10% over budget.

SWELLING WELFARE ROLLS. Now the outlook is even more dismal. As layoffs mount in the airline and tourist industries, the rolls of those eligible for jobless benefits, welfare, and Medicaid will swell. Airlines alone announced more than 100,000 layoffs in the weeks following the terrorist attacks. Nevada lost the revenue from some 78,000 visitors when hundreds of conventions scheduled through the end of October were canceled. The state, which collects no income tax, relies on taxing tourists for 75% of its general revenue. In

Hawaii, Governor Benjamin J. Cayetano is convening a special session of the legislature on Oct. 15 to consider dipping into tobacco-settlement and hurricane-relief funds.

It's not just tourist destinations that will be hurt. Manufacturing layoffs in the big states have put a dent in unemployment fund surpluses (table). Michigan is facing budget problems "similar to the situation in the early 1980s and 1990s, when there were recessions," says Mitchell E. Bean, director of Michigan House Fiscal Agency, a legislative budget bureau. The auto industry has already trimmed employment rolls there by 11%, or 34,000 jobs. Welfare caseloads are climbing at a rate of 7%. Michigan may tap its \$1 billion rainy-day fund and make emergency budget cuts.

The state of Washington has been hit particularly hard by the fading fortunes of its largest employer, Boeing Co. With 30,000 layoffs at Boeing due to declining sales of passenger jets, state officials expect the current budget shortfall of \$101 million to reach nearly \$900 million.

States such as Illinois are looking to defer spending. Chicago had planned to reconstruct Soldier Field, home of the NFL's Chicago Bears, with \$399 million in bonds backed by a 2% hotel tax. But the occupancy rates of downtown hotels have

dropped to 50%—from 70% to 90%—since September 11. At Chicago's O'Hare International Airport, a planned \$6 billion, 15-year expansion of six runways to relieve congestion is in doubt. Income generated by taxes, takeoff and landing fees, and concessions will likely be far below last year's \$511 million.

Airports are crucial to many local economies. In Washington, where Reagan National Airport was closed for three weeks and only just reopened on an abbreviated schedule, a \$100 million bailout for the local travel industry is in the planning stages.

The situation is also dire in Florida: Tourism, the largest industry, supplies 25% of taxable income. At Chef Allen's, an upscale restaurant in Aventura that suffered more than \$10,000 in cancellations in the first week, bookkeeper Susan Leerstang laments: "People who live here aren't coming, either. We've been shaken to our very core." As a result, Governor Jeb Bush

says Florida's current budget shortfall may grow to \$1 billion.

No one expects that state budgets will be permanently downsized, but the current fiscal year will likely be a rough one as legislatures either cut spending or raise taxes. Neither option is likely to improve local economies.

By Paul Magnusson in Washington, with Ann Therese Palmer in Chicago, Christopher Palmeri in Los Angeles, and bureau reports

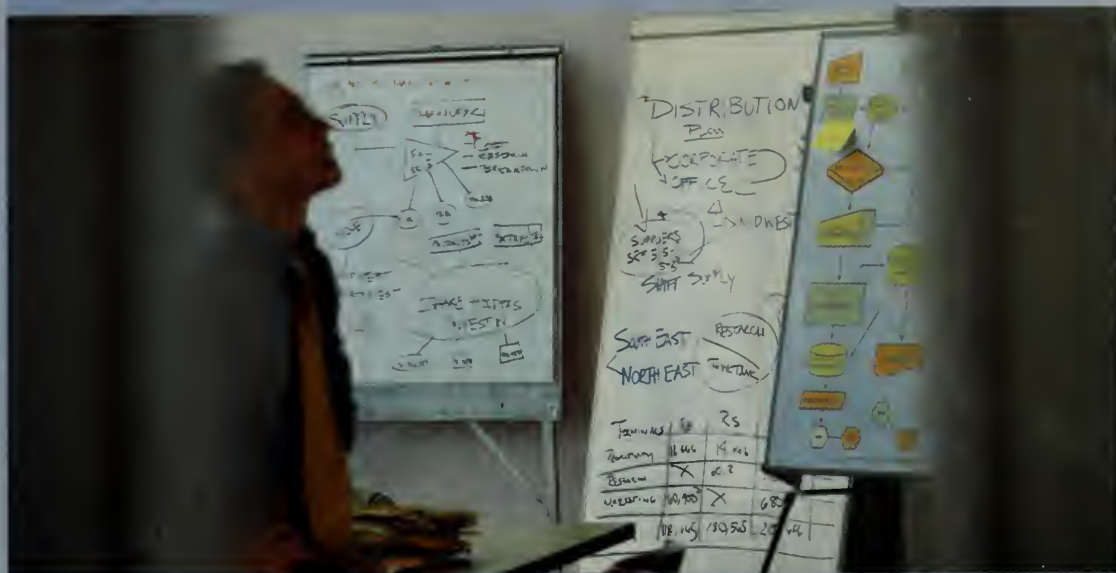
ALREADY AT RISK

States whose unemployment funds were furthest below federal guidelines prior to September 11

STATE	NUMBER OF MONTHS ITS SURPLUS CAN COVER HIGH UNEMPLOYMENT*
NORTH DAKOTA	3.4
NEW YORK	3.6
ILLINOIS	5.8
WEST VIRGINIA	6.1
MISSOURI	6.6
MINNESOTA	7.0
OHIO	7.4
ALABAMA	7.7
ARKANSAS	7.9
PENNSYLVANIA	7.9
U.S. AVERAGE	10.7

Based on a federal guideline derived by averaging a state's three largest unemployment-benefit payout years. Assumes no additional funds.

Data: Labor Dept.



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TELECOMMUNICATIONS

AT&T HITS A \$5 BILLION WALL

A cash crunch weakens its hand in merger talks with BellSouth

Will Mike Armstrong ever get a break? Just as AT&T is embarking on a possible merger with offshoot BellSouth Corp., *BusinessWeek* has learned he now has to navigate a treacherous cash crunch.

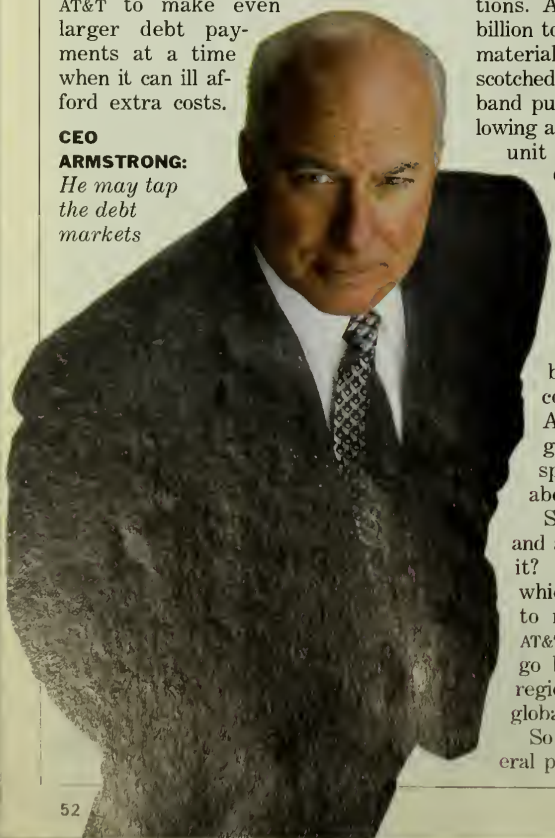
Armstrong announced Oct. 3 that AT&T would cut capital spending at the core telecom unit next year by 20%, or about \$1 billion. And one AT&T source says the \$3.5 billion capital budget at its cable unit could be cut by up to \$1 billion. Armstrong is also contemplating a debt offering of as much as \$5 billion to \$6 billion to bolster its reserves, according to sources. Those reserves had stood at \$9.7 billion at the close of the second quarter. AT&T's current cash level won't be released until third-quarter financial results are announced later this month.

"LITTLE LEVERAGE." AT&T execs won't comment on their cash position. But the need to raise funds is a stark sign that AT&T's bind is far worse than many on Wall Street now realize. It will force AT&T to make even larger debt payments at a time when it can ill afford extra costs.

CEO

ARMSTRONG:

He may tap the debt markets



Even more critical, added debt will give the telecom giant little negotiating room with BellSouth. "AT&T has very little leverage. They are at the mercy of whomever wants to purchase them," says Scott Cleland, CEO of Precursor Group, a telecom research firm in Washington.

How did things go from bad to worse in seemingly no time at all? For starters, AT&T has been unable to raise urgently needed cash through sales of its minority stakes in cable outfits Time Warner Entertainment and Cablevision Systems Corp. AT&T had hoped that AOL Time Warner Inc. would pony up roughly \$9 billion for the Time Warner stake alone, but the two sides have been bogged down in price negotiations. An additional \$7 billion to \$9 billion never materialized when AT&T scotched the AT&T Broadband public offering, following a bid for the cable unit by Comcast Corp. in August.

The economic slowdown has also taken a big toll. Even before the terrorist attacks last month, both its business and consumer units had been falling off sharply, insiders say. With prices falling, AT&T has been rapidly losing share in the consumer long-distance market. And industrywide revenue growth from the sale of high-speed data services is only 15%, about half what was expected.

So why does BellSouth want AT&T and all the problems that come with it? For Atlanta-based BellSouth, which delivers local phone service to nine Southern states, snaring AT&T would enable the Baby Bell to go beyond its current status as a regional player, and it would deliver global corporate customers.

So far, the talks have included several possible scenarios. AT&T may sell

its cable business to Philadelphia-based Comcast. That would give Armstrong free hand to cut a deal to combine the remaining consumer and business-services units with BellSouth's local-phone networks. Alternatively, BellSouth might even bid for all of AT&T, including its cable assets. The terms of any deal and who would run the new company are still open, though Armstrong is looking for a merger of equals. BellSouth declined to comment, but one inside source confirmed serious talks are underway.

Now, adding to all the other complications is the prospect of a big chunk of new debt. Moody's Investors Service already has AT&T on credit watch with a rating of A2, the lowest level in its to-

CASH BIND

CANCELED IPO After Comcast bid for AT&T's cable business in August, AT&T canceled plans for a \$9 billion cable IPO.

STALLED SALES AT&T has been unable to sell its minority stakes in Time Warner Entertainment or Cablevision. CEO Armstrong had hoped to raise \$9 billion from the Time Warner stake alone.

MARKET WEAKNESS AT&T's deteriorating core markets—voice and data for both consumers and businesses—have hurt cash flow.

tier. Standard & Poor's also has AT&T under credit watch with a rating of A. Far more critical, any new evidence of financial problems at AT&T could reduce the price BellSouth CEO Duane Ackerman is willing to pay.

MISGIVINGS. Moreover, there's still dissent within BellSouth over whether or not AT&T is a suitable partner. One faction within management feels that "Sprint is much closer to BellSouth in terms of its fiscally conservative management style and is much better managed than AT&T," says one source.

Those doubts are well placed. All long-distance companies suffer from falling prices and slowing growth. And BellSouth would inherit AT&T's stake in bankrupt Internet company, Excite@Home, as well as its troubled Concert venture with British Telecommunications PLC.

If a deal doesn't get done, the downside may be felt by the entire telecom sector. Consolidation could help bring about a healthier, leaner industry, or reason why regulators might approve reunion of AT&T with a part of the original Bell system. "Approval is possible, although it would have Kevla strength conditions," says Precursor CEO Cleland. AT&T might have to divest its assets in BellSouth's home market in the Southeast, "down to every last paper clip." That just might be a price Mike Armstrong would willingly pay.

By Steve Rosenbush in New York with Ron Grover in Los Angeles and Charles Haddad in Atlanta

"Gray hair and net-savvy are no longer mutually exclusive. Successful online retailers must base their growth strategies on the reality of a maturing user and buyer base."

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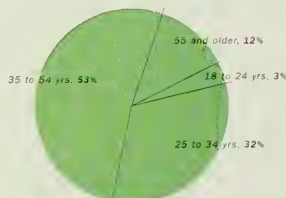
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The Internet market you're overlooking: go for the gray

By David Schehr

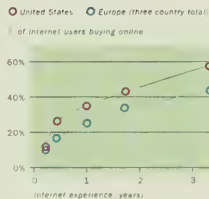
Online buyers by age



Online retail spending in Q1 2001: \$7 billion

Base: U.S. adult Internet buyers (73 million)
Source: GartnerG2 and U.S. Department of Commerce

Online buying, by length of Internet experience



Base: Adult Internet users (U.S., France, Germany, U.K.)
Source: GartnerG2

Viewpoint

- Most online marketing is focused on the Net Generation—young adults under 35.
- Older consumers spend more online. As Willie Sutton said when asked why he robbed banks: "That's where the money is."

Dynamics

- Average Q1 2001 online spend for seniors was \$92; for Gen Y, \$40.
- U.S. consumers over 35 accounted for nearly two-thirds of all online buying in Q1 2001. One reason: There are more of them.
- Older consumers are harder to please, online and off.

Predictions

- Buy/browse ratios are near saturation, so growth rates of new U.S. online buyers will stay in the low single digits.
- Online buying in the United States will top out at between 60% and 65% of the online population over the next five years.
- In Europe, buying levels will be lower. Fewer than half of all Europeans with three years' internet experience will buy online.

Recommendations

- Attract new users to your site early, so when they are ready to buy, they buy from you. Make the browse enticing; the buy will follow.
- Target older U.S. consumers, especially the "young old" (55 to 69). Pay special attention to customer service. They certainly do.

Dig Deeper

- Related Research from GartnerG2
- Gartner Core Research
- Other Sources
- Methodology

David Schehr, GartnerG2 Research Director, has over 20 years' experience in consumer behavior and marketing research across a variety of industries—including financial services and consumer packaged goods. For the past five years, David has focused on market opportunity and strategy.



For full report: www.bethetweezers.com
or visit: www.gartnerG2.com



NEW ORDER: *Bezos is using partners instead of trying to sell everything*

Maybe so. Still, it's a big comedown: Amazon is attempting to become less of an online department store and more a retailing back office. The upstart many people thought would knock off brick-and-mortar giants now aims to be their best friend. These days, servicing other retailers using its existing logistics, customer service, and Web-site operations looks like a surer route to profits than selling lawn furniture. Says Jupiter Media Metrix Inc. analyst Ken Cassar: "Amazon has come to the realization it can't be the dominant force in retail it once hoped."

Bezos, no doubt, wouldn't quite put it that way. But, truth is, Amazon is well into the process of discarding the sell-everything retailing concept. Last year, it inked a deal to take over the Toys 'R' Us online site, running it as a store on Amazon and handling fulfillment. Earlier this year, Borders did the same, online travel provider Expedia began offering products on Amazon's site, and Circuit City said it will start selling on the site in November. In July, AOL Time Warner Inc. bought a \$100 million stake in Amazon and will use its technology in AOL's shopping areas. All told, services deals are expected to total sales of more than \$200 million this year.

HIGH IMPACT. With gross margins of 60% and up, more than double Amazon's overall gross margins, such deals have an outsize impact on earnings. In the second quarter, \$4.3 million in services profits were enough to tip the entire U.S. business into the black. In the fourth quarter, Rashtchy reckons the Target and Expedia deals alone will bring in up to \$7 million in operating profit—potentially enough to produce that promised companywide profit.

At just 7% of sales, services remain small potatoes. They alone probably won't get Amazon over the hump. Bezos will

also have to slash costs. One worry: If a sales slump persists, Amazon could run out of cash as bills for holiday inventory come due in January. So, Bezos may do best to ditch money-losing items, such as kitchen products—and the sooner the better. "He's got to do a deal with the top category leader in each area," says Patricia B. Seybold of market researcher Patricia Seybold Group Inc.

The question is whether he can do enough of them, fast enough, for Amazon to survive on its own.

By Robert D. Hof in San Mateo

TAILING

AMAZON: 'WE'VE NEVER SAID WE HAD TO DO IT ALL'

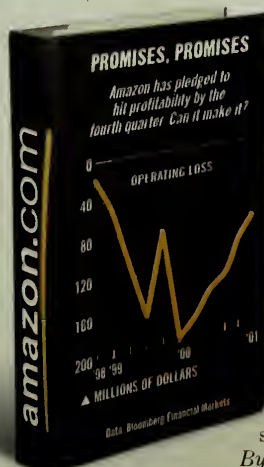
ff Bezos has been forced to scale back his ambitious agenda

In any other day, it would've been big news. Pressured to show a path to profits after years of losses, Amazon.com Inc. was to announce that discounter Target Corp. would open an on-store on Amazon's home page this week. Target would pay the e-tailer to sell products such as apparel and jewelry, and would hire it to run the Target Web site. For Amazon, the timing seemed perfect since the deal promised millions in high-margin business. Just one problem: The news crossed the wires at 8:39 a.m. on September 11, six minutes before the hijacked jet crashed into the World Trade Center.

Far from getting a boost from the recently noticed deal, Amazon now finds itself deeper in the soup. Fears that the ailing economy will send consumer spending into a slump have prompted most analysts to cut Amazon sales estimates for the just-ended third quarter to less than \$650 million, nearly flat vs. a year ago. Worse, many increasingly question whether the e-tailer will earn a promised fourth-quarter pro forma operating profit. Investors have knocked down Amazon's stock by nearly 60% since mid-July, to around \$7 a share, on concern that Amazon could run out of cash in early next year. Says Safa Rashchy, analyst with U.S. Bancorp Piper Jaf-

fray: "They have to show the Street they can make money."

Analysts now say Amazon could still earn the \$6 million fourth-quarter operating profit most had expected before September 11, especially if the benefits from the Target and other similar deals start to kick in. Even if they do pay off, Amazon won't be off the hook. For the company to remain independent, founder and Chief Executive Jeffrey P. Bezos needs to scale back his oversize ambitions. By its own definition of pro forma operating profits, Amazon earned \$39 million selling books, CDs, and videos in the second quarter. But that was wiped out by the \$41 million in domestic losses from trying to sell everything from drill presses to KitchenAid mixers. So, Amazon increasingly aims to get other retailers to sell their wares on the Amazon site. "We want to be the place for people to find and discover anything they want to buy online," says Bezos. "But we've never said we had to do it all."



EDITED BY MONICA ROMAN

A DRUGMAKER GIVES SENIORS A BREAK

BRITAIN'S GLAXOSMITHKLINE will offer discounts of up to 40% to low-income seniors beginning Jan. 1, 2002. The program is the first of its kind in the pharmaceutical industry, which is coming under pressure to increase access to lifesaving medicines for low-income patients. GSK, the world's second-largest drugmaker, hopes the move will ensure access to medicines for the estimated 30% of U.S. retirees without prescription drug coverage while Congress debates Medicare. The discounts will be available to 11 million Americans age 65 and older who have no public or private prescription drug coverage and whose incomes are at or below \$26,000 per person and \$35,000 per couple. Seniors will receive a card that they can present at their pharmacies for discounts on such GSK drugs as antibiotic Aug-

mentin, diabetes treatment Avandia, and asthma medicine Advair.

AND THE WINNER AT MOTOROLA IS—BREEN

IN A MOVE APPLAUDED BY Wall Street, Motorola promoted Edward Breen to succeed Robert Growney, 59, as president and COO as of Jan. 1. Although an outside search was conducted, Breen, currently president of Motorola's networks sector, had been the favorite. Breen, 45, was chief executive of General Instrument, which merged with Motorola in January, 2000. The no-nonsense Breen is regarded as the kind of executive who can get Motorola's sputtering businesses humming again.

HALF-EMPTY PLANES, HALF-PRICE TICKETS

EAGER TO GET TRAVELERS back into the air, the two biggest U.S. carriers, United Airlines and American Airlines, cut advance-purchase, unrestricted coach fares by 50% on Oct. 2. US Airways quickly followed. Meanwhile, Delta Air Lines and Continental passed out free tickets to New York. The airlines have little choice. Most major carriers report their planes are still flying 40% empty, even after trimming their schedules by 20% since September 11. But low fares may not work. Road warriors aren't flying because their employers are trying to salvage profits. Staying put is still cheaper than buying half-price tickets.

WILL BAYER MAKE HAY WITH CORN?

GERMANY'S BAYER, ONE OF the world's remaining chemical-and-drug conglomerates, agreed to pay \$6.6 billion for

HEADLINER: JACK WELCH

WELL, THAT WAS QUICK

JACK WELCH LOVES SUPERLATIVES. Now he may have another: the world's shortest retirement. The former General Electric chief has started consulting with high-level clients and, on Oct. 2, was named a special partner at the investment firm Clayton, Dubilier & Rice. What everyone wants, it seems, is that special touch that turned GE into the world's most valuable company during Welch's 20 years at the helm. Clayton Dubilier CEO Donald Gogel speaks of "the halo effect" and says Welch is free to dabble in whatever projects



spark his interest. Says Gogel: "We're looking at him for his counsel, instincts, judgment, force of personality, and character." No word on fees, but it's clear Welch's words won't come cheap. Except, of course, when he begins stumping once again for his best-selling book *Jack: Straight from the Gut*. His six-week book tour was to kick off on September 11—four days after he retired. On Oct. 5, he'll head to Europe for interviews and resume the U.S. push about a week later. Then it's back to work.

Diane Brad

Aventis CropScience, the Strasbourg-based maker of genetically modified corn. The deal will make Bayer the second-largest player in the \$33 billion global agrochemicals industry. The 138-year-old company, best known for its discovery of aspirin, clearly needs help. Investors are pressuring it to sell or spin off its lackluster drugs unit. And since Bayer's new cholesterol-lowering drug, Baycol, was yanked from the market in August after 52 patients died, its shares have fallen by a third.

for California's year-and-a-half long electricity crisis. Elect rates, which have leapt high as 45% this year, will be directed toward paying debt. In return, Edison agreed not to pay dividends until 2003. The plan settles a federal lawsuit filed by Edison against the commission that bypasses state legislators, who failed to come up with a bailout. Still, consumer advocates complain that the deal prevents ratepayers from benefiting from recent declines in wholesale electricity prices.

A UTILITY SETTLES IN THE WEST

IN A SURPRISE MOVE, THE California Public Utilities Commission announced a settlement with Edison International. The deal will pay off some \$3.6 billion of the utility's debt and settle a feud over who should foot the bill

ET CETERA...

- Merrill Lynch is replacing its foreign brokerage and investment banking unit head
- Cisco Systems' executives were not paid bonuses in fiscal 2001.
- Eli Lilly will miss fourth quarter earnings estimates because of generic competition for its antidepressant Prozac

CLOSING BELL

SAFE SOARING

B/E Aerospace soared 54% on Oct. 1 and 2, to \$11.73, after the Wellington (Fla.) company said its new cockpit security system could be on the market by January. B/E shares slid 13% on Oct. 3, but insiders, who purchased 248,000 shares in September at prices ranging between \$4.18 and \$6.85, are still safe.



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EDITED BY RICHARD S. DUNHAM

CAN TOM RIDGE TAKE ON THE TERRORISTS? IT'S UP TO BUSH

As the first-ever Director of Homeland Security, Tom Ridge is responsible for protecting America from terrorist attack. But on Oct. 8, as Ridge takes leave of the Pennsylvania governor's mansion for new West Wing digs, it's he political land mines he'll need to avoid.

Ridge already is being called the antiterrorism czar, a label that implies political impotence. After all, Washington's landscape is littered with failed czars—inflation czars, cancer czars, drug czars, education czars. Despite President Bush's promise that his antiterrorism chief will have cabinet-level status and undefined control over 6 agencies and \$11 billion in counterterrorism pending, the betting is that the czar won't get far unless he can give orders and control loose strings.

That's typical Washington pessimism. Ridge's success will depend not on money or legal authority, but on President Bush. It will be up to the Prez to give his longtime friend a call-anytime invite to the Oval Office. Bush will need to herald Ridge's policy recommendations with prime-time pomp to establish the czar's place in the political constellation. And Bush must make an example of anyone who tries to undercut Ridge. "You've got to empower Ridge in a way we've not seen before," says professor William Martel of the Naval War College in Newport, R.I. "You've got to make clear that his person is first among equals."

DEA MAN. With a staff of 100 borrowed from key bureaus such as Health & Human Services and the Federal Emergency Management Agency, Ridge must open lines of communication between rivals. He'll need to evaluate technology to close gaps in the nation's defenses. And he must serve as clearinghouse for ideas, such as issuing national I.D. cards for stockpiling smallpox vaccines.

Congress supports Ridge, but some members fear he'll

fail without heavy artillery. They want to replace Ridge's bully pulpit with a Cabinet agency. "Ridge should have at least as much power as he had as governor of Pennsylvania, but I don't think he will," says Senator Joseph I. Lieberman (D-Conn.), chairman of the Governmental Affairs Committee. Lieberman and Representative William "Mac" Thornberry (R-Tex.) want to shift billions of antiterrorism dollars from agencies such as the Coast Guard and Customs to a centralized bureau. "Ridge will be able to get things done for a while," Thornberry reasons. "But one of these days, some bureaucrat is going to say: 'What if I don't do what you say?'"



MOMENTUM: Ridge

Still, giving Ridge more firepower would lead to months of bureaucratic and political upheaval when Washington needs it least. Ridge already has many of the tools he needs, including experience as a governor, congressman, and Vietnam vet. Daniel P. Moynihan, an erstwhile social policy czar, proved that a desk and a typewriter in the Johnson and Nixon White Houses could be powerful tools in battles such as the war against poverty.

Ridge's Oct. 8 arrival also has the benefit of symbolic timing: He takes up his duties almost a month after the September 11 attacks. That is not to say that when the flag waving stops and America settles into a long, low-key war, passions for battling terrorism won't cool and Ridge won't be left to fight lonely skirmishes with agency heads unwilling to give up money or turf.

So it is imperative for Ridge to establish early on that when it comes to matters of domestic security, he speaks for the President. Congress should give the czar a chance while he has momentum and goodwill. Then, if Bush-style Homeland Security fails, lawmakers might want to dust off their plans for another Greek Revival temple of Big Government.

By Lorraine Woellert

CAPITAL WRAPUP

BACKSEAT FOR NET PRIVACY

► Privacy advocates had high hopes that George W. Bush would champion their cause. During the 2000 campaign, Bush told *BusinessWeek* that he was a "privacy-rights person." Customers "should be allowed to opt in" to sharing information, he said. "The company has got to ask permission."

But since September 11, Attorney General John Ashcroft has pressed for expanded wiretap powers. And now Federal Trade Commission Chairman Timothy J. Muris is reversing the

agency's previous call for tough new Internet privacy laws. Says Muris: "We don't need new laws, we need more law enforcement."

Privacy advocates blast the Bushies. "It seems they are taking steps backward," says Ari Schwartz of the Center for Democracy & Technology.

Instead of legislation, Muris will boost the FTC's privacy staff by 50% to sniff out identity thieves, deceptive spammers, and companies that violate their own privacy policies. He also plans to set up a national "do-not-call" list consumers can get on to avoid ha-

arrassment by pesky telemarketers.

Key pro-privacy lawmakers are forging ahead anyway. "I think Muris is wrong," declares House Energy & Commerce Chairman Billy Tauzin (R-La.). "We can't have California writing one rule and Oregon writing another."

With Tauzin and Senate Commerce Committee Chairman Ernest F. Hollings (D-S.C.) pushing for action, the issue won't die soon. But without Bush's help, it'll be difficult to get a privacy law through a Congress more concerned about terrorism than tech.

By Amy Borrus



TURMOIL IN THE

Across most of America, life is creeping back to normal as the nation mourns those lost in the September 11 terrorist attack. Not so in the Islamic world. The aftershocks of the disaster—and the certainty of U.S. military retaliation—are aggravating dangerous social, political, and economic fault lines across Central Asia, the Middle East, and even Southeast Asia. The underground economy of Pakistan is crumbling. The struggling Central Asian states of Kazakhstan

SEEKING SAFETY

Afghan refugees in Quetta, Pakistan

CENTRAL ASIA

THE 'STANS' SEIZE THE DAY

Central Asia's former Soviet republics hope for big gains

Rife with corruption, their impoverished economies are still mostly controlled by the state. In varying degrees, their rulers censor the press, restrict religious worship, and limit political opposition. Before the September 11 terrorist attacks on the World Trade Center and the Pentagon, these states won notice in America chiefly from indignant human-rights watchdogs. But now the wheel has turned: The U.S. government is eagerly courting these countries' assistance in its urgent hunt for chief suspect Osama bin Laden in neighboring Afghanistan.

They are "the stans," the five former republics of the Soviet Union in landlocked Central Asia: Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan. Faced with the threat of Islamic insurgencies from bin Laden-linked groups, the autocrats governing these states are wagering that a decisive U.S. military assault on the bin Laden network—and its Taliban sup-

porters—would bring an elusive security to their own fragile regimes.

And that's why, from their perspective, the sudden and unexpected U.S. interest in their remote patch of the globe—total population 55 million—is welcome. Their chief concern is that a fickle America, after capturing bin Laden, will leave the region helpless to stem festering political and economic ailments. Seeking to reassure the leaders, Defense Secretary Donald H. Rumsfeld left for a visit to the Middle East and Central Asia on Oct. 2.

ILL-FATED. Early signs are that the formula for cooperation is working well—even though the partners are so vastly different. The U.S., the world's wealthiest country, with a per capita gross domestic product of \$36,500, is teaming up with five of the world's less fortunate members, whose average per capita GDP is just \$766. Kazakhstan, along with Tajikistan and Uzbekistan, both of which have a direct border with Afghanistan,

have offered their territories for the basing of U.S. troops. Kyrgyzstan and Turkmenistan have tendered airspace rights. And even though he's concerned about the U.S. gaining a foothold in a region he views as part of his country's own sphere of interest, Russian President Vladimir V. Putin, who faces his own bin Laden-linked uprising in Chechnya, has blessed the arrangements.

Uzbekistan's President, Islam A. Karimov, a former communist boss, is extending an especially warm greeting to America. That's no surprise; he may be the region's least secure leader. In February, 1999, he was nearly killed by car bombs in the capital city Tashkent, an assault that probably was the work of bin Laden-linked group, the Islamic Movement of Uzbekistan (IMU).

Based in Tajikistan and Afghanistan and numbering up to 3,000 guerrillas, the IMU advocates Karimov's overthrow. Its aim is to establish strict Islamic law in Uzbekistan, a country of 24 million that is 88% Muslim but lives under secular rule. Uzbekistan, which has an 84-mile border with Afghanistan, was the staging ground for the Soviet Union's ill-fated 1979 invasion of that country.

Now, the same airports that hosted those Soviet troops are accepting C-17 U.S. military cargo planes, according to sources in Tashkent. What's more, the Pentagon is sending to Uzbekistan troops from the Army's 10th Mountain Division. In his Sept. 20 speech to Congress, President George W. Bush named Karimov a plum: He singled out the

MUSLIM WORLD

Uzbekistan, Tajikistan, Turkmenistan, and Uzbekistan are now on the front lines of a possible U.S. attack on Afghanistan. Militant Islamic groups are asserting themselves in an Indonesia still struggling to overcome the effects of the Asian crisis. With fragile governments forced to side with or against the U.S.-led campaign against terrorist networks, the repercussions from this conflict in the Muslim world could last years.

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BusinessWeek online

For related stories on the Persian Gulf states and India-Pakistan relations, go to the Oct. 15 issue at www.businessweek.com.

IMU as part of bin Laden's Al Qaeda network and ordered a freeze on its assets. "Now, there is a unique chance to destroy the IMU squads," says Alisher Ibratov, an ex-Uzbek Foreign Ministry official in Tashkent. "U.S. policy in Uzbekistan suits Uzbek interests."

Then there's Tajikistan, which serves as the main supply channel for the Russian-backed Northern Alliance in Afghanistan. That coalition, led by ethnic Uzbeks and Tajiks, is the principal source of military opposition to the Taliban. Torn apart by a civil war between communist and Islamic forces that ignited after the Soviet Union collapsed in 1991, Tajikistan remains host to 17,000 Russian troops. They guard a border that has become a haven for heroin smuggling, one of the nation's only booming businesses. Russian-backed President Imamali Rahmonov hopes America can be a stabilizing influence—aid a source of financial aid. On Oct. 2, the European Bank for Reconstruction and Development announced a \$13 million loan to Tajikistan to modernize its telecom network—nearly doubling its commitment to that country.

But if the leaders of the Central Asian states are now seeking closer ties with the U.S., their citizens have mixed feelings. Envied as wealthy and powerful, the U.S. also is resented as a

TAJIKISTAN

Russian soldiers keep watch on the country's border with Afghanistan



meddler in fellow Islamic countries. These sentiments are common not only among the fervently religious but also among secular elites, such as professors. Moscow-based analyst Alexei Malashenko of the Carnegie Moscow Center says that on a recent trip to Kyrgyzstan, he encountered widespread anti-Americanism among intellectuals, who called the September 11 attacks "a punishment" for America.

OIL RICHES. One reason America is not better liked is that so few of its riches have made it to Central Asia, which wants to become a new "Silk Road" trade route between Western and Eastern market economies. With the exception of Kazakhstan, which has joined oil majors Chevron Corp. and Exxon Mobil Corp. to develop vast oil reserves near the Caspian Sea, the Central Asian nations have attracted scant foreign investment. In Tajikistan, 60% of the population earns less than \$7 per month, says the EBRD. In comparatively wealthy Uzbekistan, the average monthly salary is below \$50. Families in the fertile Fergana Valley, the most densely populated part of Uzbekistan and the place in which Islamic militants have made the greatest strides, manage by growing their own fruits and vegetables.

Of course, foreign investors have good reason to be wary. Promises of economic reform generally have not materialized. In April, the International Monetary Fund pulled out of Uzbekistan, citing its antimarket policies. Deals in the region hinge less on the rule of law than on the whim of government ministry officials.

It is conceivable that a successful U.S. operation against bin Laden could break this bleak cycle. The most hopeful scenario, sketched by S. Frederick Starr, chairman of the Central Asia-Caucasus Institute in Washington, goes like this: The U.S. extracts bin Laden, defeats the Taliban, and a postwar Afghanistan offers a welcome mat to Western investment. New trade routes and energy pipelines open up across the region.

Then, with prodding from the U.S., heavily engaged as an economic partner, the Central Asia states liberalize their economies and political systems. "We have the opportunity, not only to set Afghanistan on a better course but to pull the cork that has bottled up the economies of Central Asia," Starr says. Maybe, but it will be a long, arduous road. For now, mum's the word in Washington on the repressive policies of America's prize recruits in its new global war to defend U.S. liberties.

By Paul Starobin in Moscow



THE BORDER

DARK DAYS FOR A BLACK MARKET

Afghanistan and Pakistan rely heavily on smuggling

Ever since the September 11 terrorist attacks on the U.S., life at Pakistan's Karkhanai Bazaar near the border with Afghanistan hasn't been the same. Normally the market is thronged with people shopping for Japanese TVs, Chinese bicycles, and Korean household goods smuggled across the border to avoid onerous Pakistani customs duties of up to 100%. But these days, in the wake of stepped-up border controls, smugglers are leery of sneaking across. As a result, Sharif Ullah, a 19-year-old Afghan porter, has too little work and too much time to fret about the situation back home in Kabul. "People are afraid of the U.S. attacks," he says, leaning against his empty handcart. "Uncertainty is everywhere."

The uncertainty is a threat to the

livelihood of tens of thousands of people like Ullah. That's because the free flow of contraband and drugs plays a critical role in the fragile, ragtag economies of Pakistan and Afghanistan. If the illicit trade is disrupted, it could ultimately determine the fate of the government on both sides of the border. "It's hard to see how the Taliban could sustain much of a war if all economic activities are disrupted," says Barnett R. Rubin, New York University professor and a leading authority on the region.

MILITANCY. That's good for the U.S., which wants to undermine the Taliban any way it can. Trouble is, any long-term interruption in smuggling will just "compound the problems" of Pakistan, President Pervez Musharraf, says Rubin. A worsening economy could stoke

SMUGGLING WOES

Stricter controls on the Pakistan-Afghan border could end up undermining both economies

Islamic militancy among the underclass and worsen an already chaotic law-and-order situation along the border. That's the last thing Musharraf needs as he contends with a populace deeply divided between pro- and anti-U.S. sentiment. Already the slowdown is spreading through Pakistan, where everything from car parts and Sony PlayStations to heroin is sold in black-market bazaars, or *baras*. The stealth economy is said to be worth at least \$30 billion, or

if Pakistan's official gross domestic product.

In Afghanistan, the underground economy plays an even larger role. In a country that for years has produced nothing more than food and opium, smuggling is an economic driver. Electronics from Dubai, cosmetics from Iran, shoes from Turkmenistan, food processors from Japan—all move through Taliban-controlled Afghanistan and into Pakistan. Not only will the slowdown in smuggling put thousands of traders out of work, it could also threaten the Taliban's tenuous hold on power. The levies the Taliban imposes on smugglers and drug traffickers help it to purchase weapons, run what little government exists, and most crucially, buy the loyalty of local chiefs and warlords.

Smuggling has been a feature of this trading crossroads for millennia. And it got a boost in the 1950s when landlocked Afghanistan negotiated a deal with Islamabad that allowed goods to pass from the port of Karachi through Pakistan and over the Afghan border duty-free. The pact has a fancy name: the Afghan Trade Transit Agreement (ATA). But it merely provided a cover for smugglers. Nearly all of the goods bound for Afghanistan find their way back into Pakistan.

The scheme is called the "U-Turn." It works like this: A buyer in Afghanistan

issues a letter of credit to import, say, a load of air conditioners through Karachi port (map). The appliances are then transported across the Afghan border 620 miles away. The trucks unload on the Afghan side and drive back across to Pakistan empty to wait while the air conditioners reenter Pakistan illegally, carried by camels, donkeys, or on the backs of tribesmen living along the rugged 1,550-mile border. The goods, which sell for far less than legally imported items in Pakistan, are distributed via a trucking industry largely controlled by Afghan refugees. According to the World Bank, the illegal trade amounted to \$2.5 billion in 1997; about \$75 million went to the Taliban.

Pakistan's government has made half-hearted attempts to crack down on the contraband. A few years ago, acting under pressure from local manufacturers, it banned the import of TVs and other electronics under the ATTA system. Smugglers simply chartered planes to fly the goods directly from Dubai into Kandahar in Afghanistan. From there they were smuggled into Pakistan through the grasping hands of the Taliban militia.

MONEY-SPINNER. Nor has Islamabad responded effectively to pleas from locally based multinationals. Lever Brothers Pakistan Ltd., for example, says it could sell 20% more Lux soap, Sunsilk shampoo, and Lipton tea if the black market were curtailed. Company Chairwoman Musharraf Hai says 20,000 tons of tea were smuggled in over the past 12 months. "If we cannot constrain or eliminate this problem, maybe we should source somewhere else," she says.

Drugs are another major money-spinner. The gangs moving heroin through Afghanistan, Pakistan, and Iran are as sophisticated as the cocaine traffickers of Colombia. Smugglers drive in convoys of Land Cruisers equipped with satellite phones and rocket launchers. And they enjoy the protection of some of the most powerful people in Pakistan; millions of dollars in kickbacks flow right to the top of the political establishment, says a for-

mer Pakistani intelligence agent. A 2000 report by the United Nations Office for Drug Control & Crime Prevention said Afghanistan accounted for more than 70% of global opium production. "Afghanistan is to Europe what Colombia is to the U.S.," says a U.S. official.

And despite the Taliban's high-profile ban on poppy cultivation last year, law enforcement agents say the religious sect has benefited from the drug trade. UNODCCP representative Bernard Frahi says the Taliban raised at least \$18 million in 1999 through 10% Islamic levies, called *usha*, imposed on poppy farmers. How much more the Taliban took in from labs and traffickers is anyone's guess. Some even speculate that the Taliban imposed the ban on poppy farming because it feared a glut would drive down prices. Indeed, earlier this year the wholesale price of heroin soared tenfold, to \$600 a kilogram (2.2 pounds), says a U.S. official.

Now, however, the Taliban's drug revenues are at risk. Not because the border is more tightly controlled—heroin is smuggled more easily than consumer durables—but because prices have fallen to \$100 a kilo. In a drug den near Peshawar, Tajali, a green-eyed 16-year-old Afghan trader, says many traffickers are now dumping their stocks "because the Taliban has allowed people to grow again." Of course, by the time the poppies bloom next April, the Taliban may well be history. Some other group will appear to take its cut from the flow of drugs and contraband—and the underground economies of Pakistan and Afghanistan will thrive once again.

By Frederik Balfour in Peshawar



**ANGRY**

Crowds gather every day at the U.S. Embassy in Jakarta to protest American "arrogance"

Southeast Asian Studies in Singapore. But, adds Smith, "Indonesia really needs to take it seriously and nip it in the bud."

Instead, some powerful people seem intent on inflaming things. Late last month, Vice-President Hamzah Haz, a hard-line Muslim leader, said the September 11 attacks had "cleansed" America of its "sins." Such comments are bound to complicate matters for Indonesian Pres-

ident Megawati Sukarnoputri, who has put her job on the line by backing George W. Bush's war on terrorism—and is expecting \$350 million in new economic aid in return.

Americans are preparing for the worst. On Sept. 28, the U.S. Embassy announced that all nonessential people on its staff were free to leave the country. Nike Inc. ordered a "precautionary" evacuation of dependents of expatriate employees. Spokesmen for ExxonMobil, Newmont Mining, and Caterpillar say they're adding new guards and new security procedures. Freeport-McMoRan Copper & Gold says it is instituting anti-hijacking measures on its internal airline, Airfast.

What the oil and mining companies fear is that secessionist struggles in remote regions like Aceh province will morph into a holy war. By one account, bin Laden associates have already sought allies in the Free Aceh Movement, unlike a nonreligious group.

The threat of militant Islam seems remote in Indonesia—until September 11 brought the disaffected out of the shadows. Nur Ahmad, 20, unable to earn a living selling plastic sandals on the street, signed up with the Islamic Youth Movement on Oct. 2. "I dreamed a man in a black Arabian robe and a white beard told me: 'Let's go for jihad,'" says. With thousands more like Nur ready to join the struggle, American officials are watching their backs.

By Michael Shari in Jakarta

INDONESIA

IS A HOLY WAR BREWING IN INDONESIA?

U.S. companies are monitoring local rumblings carefully

In early October, a group of young Indonesian men met at a safe house on the outskirts of Jakarta. Recruits of a militant Islamic group called the Hizbulloh Front, they had come to get training in hand-to-hand combat. The lesson that evening: using their "inner spiritual power" to endure pain and overwhelm opponents. The highlight of the evening came when one recruit ground a fluorescent bulb into a salad bowl until his hand bled. He then ate a handful of the fragments.

The leader, Nauful Dunggio, 32, says when his men are ready they will fan out across Indonesia and "sweep" all Americans out of office buildings, five-star hotels, and gold mines. Then they'll take the infidels to local airports and tell them: "Because of your government's arrogance, you cannot live safely in Indonesia." If the infidels resist, Dunggio says, they'll be beaten.

Are these guys for real? Are militant groups such as the Hizbulloh Front a real threat to American interests? The fear that they may be is sending

jitters through the diplomatic and corporate compounds of Jakarta. After all, Indonesia is an unstable nation of more than 220 million Muslims, where hundreds of thousands of unemployed youths seem ripe for recruitment to the fundamentalist cause. But Indonesian Muslims have relatively little history of religious extremism, with much of the violence that erupts in the archipelago keyed to political and ethnic grievances.

MALL BOMBS. Still, two explosions recently ripped through the Atrium, a glitzy Jakarta shopping center owned by Chinese-Indonesian tycoon Sofian Wanandi. A suspect in the first attack was a Malaysian trained in Afghanistan. In late September, Islamic militants, dressed in black and wielding farm tools, raided hotels in the Javanese city of Solo in a fruitless search for Americans.

So far, there is little hard evidence that Islamic terrorists have made serious inroads into Indonesia. "There are only 9 or 10 of these groups, and they're very small," says Anthony Smith, an expert on Indonesian politics at the Institute of

"I dreamed a man in . . . a white beard told me: 'Let's go for jihad'"

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SAUDI ARABIA

A PRINCE WITH DIVIDED LOYALTIES

Alwaleed has a huge stake in the West but questions U.S. policy

Saudi Arabia's Prince Alwaleed bin Talal bin Abdulaziz Al Saud reacted to the September 11 terrorist attacks as most sane people did: with shock and outrage. As the horror unfolded on eight television monitors in his office in Riyadh, Alwaleed rushed to reach New York friends and associates, including Citigroup Chairman Sanford Weill. Days later, after his emotions calmed, Alwaleed began devising an investment strategy for a world that began sliding into recession almost immediately after the attacks. He's seeking buying opportunities. "I'm not panicking, and I'm not scared," says the 43-year-old nephew of the Saudi king. "I've been through the Gulf War, the Asia crisis, and the Russian crisis."

But the response to the attacks—a U.S.-led global war on terrorism, particularly fundamentalist Islamic terrorism—has far more implications for the Saudi royals than those situations. In many respects, Alwaleed is emblematic of his country's sometimes ambiguous relationship with the West. A world-class financier, he built his fortune by taking stakes in top U.S. companies when they faltered, reaping huge rewards as they recovered. Before the attacks, he valued the portfolio of his company, Kingdom Holding, at \$20 billion. As such, his economic interests are tied to the U.S. He's also a devout Muslim committed to Islamic and Arab causes—and a generous philanthropist

in a region where terrorist groups have tapped a tradition of charitable donations. Alwaleed says he's confident that none of his money ends up in nefarious hands, but he acknowledges that other donors may be less fastidious.

Since September 11, swooning share prices have hit Alwaleed's portfolio hard. Some of his top investments—Apple, Compaq, Motorola, and Euro Disney—look pretty frayed (chart). As of Oct. 2, his 3% stake in Citigroup—the fruit of a \$590 million investment in its predecessor, Citicorp, in 1992—was down just 0.5%. But his holdings are well below last year's highs. Alwaleed estimates his portfolio fell 10% between Sept. 17, when U.S. markets reopened, and Oct. 1.

NEW TENSIONS. Yet paper losses aren't his main concern. "We're getting hurt, but I'm a long-term investor," says Alwaleed. More perturbing, he suggests, is the world view reflected in President George W. Bush's declaration that those "who aren't with us are against us" in the fight against terrorism. Nothing in the Middle East—even for a U.S. ally like Saudi Arabia—is so black-and-white. "Yes, the Saudi relationship with the U.S. is very strategic," Alwaleed says. "But this incident will create tensions in the relationship."

It's hard for Americans to realize how deeply Saudis like Alwaleed feel about Islamic and Arab causes. That means funding projects that boost regional economies. One example: Alwaleed is the main investor in a \$100 million Four Seasons hotel in Damascus.

It also means more

controversial investments. Like many Saudis, including Osama bin Laden, Alwaleed was attracted by the cause of the *mujahideen* who fought the Soviets in Afghanistan. Alwaleed became a contributor to the *mujahideen* in the early 1980's when, he notes, Washington supported them. He even secretly traveled to training camps in Peshawar, Pakistan, in 1981. Alwaleed says that when Afghanistan descended into civil war after Soviet troops retreated in early 1989, he stopped supporting them. He made his last sizable donation to the *mujahideen*—\$5.4 million—in April 1990. "There are entities that are giving money now to the Afghans, but I am not involved," he insists.

Alwaleed acknowledges that bin Laden's Al Qaeda network and other

PRINCELY DOWNTURN

Alwaleed's Kingdom Holding has taken a hit

	HOLDING	SHARE PERFORMANCE 9/10 TO 10/2
CITIGROUP	3.8%	-0.5%
APPLE COMPUTER	5	-13.4
EURO DISNEY	17.3	+1.3
FOUR SEASONS HOTELS	22	-25.0
MOTOROLA	0.78	+1.3
NEWS CORP.	3.1	-12.7
MEDIASET	2.3	-17.3

Data: Kingdom Holding, Bloomberg Financial Markets

allied terrorist groups may benefit from the charitable funds collected in the Arab world. "Clearly, there have been loose ends," he says. One of the five pillars of Islam is *zakat*—giving 2.5% of one's savings each year to charity. In Saudi Arabia, where there is no income tax, people give generously. Alwaleed donated \$100 million last year. Most went to poor Saudi families. But he also gave \$6 million to Palestinian thrown out of work by the *intifada*, and he helped reconstruct Lebanese power plants destroyed by the Israeli air force.

For all Alwaleed's American style—his relaxed demeanor, his U.S. business practices, and his American slang—his loyalties are clear. What does the pro-American of Saudi princes want come out of this tragedy? "America has to understand the roots of resentment in the Arab world and the Muslim world," he says, "and we need to have high-level discussions to focus on this." If someone like Alwaleed feels this way, winning Middle East support may be even harder than America realizes.

By John Rossant in Paris



MULTIBILLIONAIRE

Alwaleed donates huge sums to Islamic charities

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COMMENTARY

By Stan Crock

STAR WARS: THE CASE FOR GOING AHEAD

When the Senate unanimously passed a defense bill on Oct. 2, it virtually ensured that President Bush will get every dime of the \$8.3 billion he sought for missile defense. Clearly, this ambitious program has not fallen victim to the September 11 terrorist attacks, as many said it would. That is for the best. For while our enemies have proven that a missile shield is no defense against some types of terrorist acts, the Star Wars endeavor may bring other benefits.

Whether or not America faces a threat from ICBMs launched by rogue states, continued funding of Star Wars helps address an immediate danger to troops President Bush may deploy. Specifically, the program helps hone technology to shoot down enemy missiles in the battlefield.

This is an argument you won't hear from Republicans intent on fulfilling Ronald Reagan's vision of a national missile shield. But both the GOP and Democrats have understood the threat ever since Iraq rained SCUDs down on Israel during the Gulf War. For years, President Clinton spent 75% of the \$5 billion missile defense budget on theater missile defense (TMD) at the expense of the more controversial national missile plan, a scheme to shelter population centers from faster, longer-range missiles.

IN FLUX. As research on TMD proceeded, the Clintonites feared it would smack into restrictions in the 1972 Anti-Ballistic Missile Treaty. Clinton tried to negotiate with Moscow limits on the capability of theater defense to avoid a fight over any potential violations. Republican conservatives balked, blasting efforts to "dumb down" defensive capabilities. Their real hope was that a souped-up version of a theater system could be the foundation for a national missile defense.

In a clever move, the Bush Administration merged the two programs, organizing the research according to

when an incoming missile is intercepted—boost phase, midcourse, or terminal phase—rather than whether it's for a battlefield- or national-defense program. Today, the research focus is in flux. But more attention will likely be given to the boost phase, which even longtime Star Wars critics say is more manageable technologically than trying to destroy missiles as they approach their targets. For one thing, this avoids the nettlesome challenge of identifying decoys deployed at later stages. And emphasizing the boost phase will bol-

sters that threaten combat troops.

If a sophisticated theater system violates the ABM Treaty, as the Clintonites feared, it wouldn't be such a big loss. Despite the constant reference to the ABM Treaty as the cornerstone of arms control, it did nothing to control arms. When the treaty was signed in 1972, Russia had 2,700 warheads and the U.S. had 12,400. By 1988, the Soviet arsenal had swollen to 15,000 warheads—partly because of new, multiple warheads on missiles. Denying troops in the field the best protection for the sake of an in-

THE GOOD NEWS ON MISSILE DEFENSE

TROOP DEFENSE Ronald Reagan didn't have SCUDs in mind, but Star Wars research will help protect soldiers in the battlefield from these and other missiles.

ACHIEVABLE GOALS Protecting a whole nation is a long shot, but even Star Wars critics say we can improve the technology to shoot down missiles shortly after they launch on the battlefield.

SHARED TECHNOLOGY Fanatics may some day go for ICBMs, as tighter security closes off their other options. At that point, some of the technology developed for battlefield defense could be applied to a national defense scheme.

ster the TMD program. "We can probably have some modest success against short-range, stable missiles," concedes one critic, Theodore A. Postol, a Massachusetts Institute of Technology physicist. As an example, he points to the upgraded Patriot, which is doing well in tests.

In any event, as a result of the bureaucratic ploys and the increased capability of theater missiles, the lines between the two programs have blurred. The sensors, software, and airborne lasers being considered for a national system could also help protect against the mis-

BETTER ODDS: Missiles are easier to shoot down in the boost phase

effective treaty makes little sense.

At some point, of course, the larger Star Wars program will hit a critical stage: It will either be deemed operational or dismissed as a Buck Rogers boondoggle. If, in the meantime, the program contributes to the protection of ground troops Uncle Sam deploys around the globe, the billions shelled out for Star Wars won't be spent in vain.

Crock covers defense in Washington



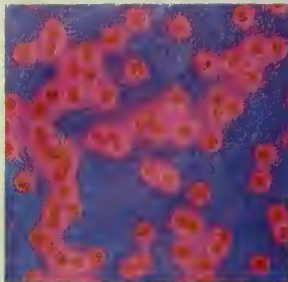
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PAPILLOMA VIRUS

THESE TESTS GO WAY BEYOND THE PAP SMEAR

EACH YEAR, 55 MILLION PEOPLE in the U.S. are infected with human papilloma virus (HPV), which can cause cervical cancer. But not all of the women affected develop tumors, and it's almost impossible to tell from a Pap test which ones will. That means millions end up back in their gynecologists' offices for painful surgical tests—many of which reveal no cause for concern.

To address this, Ventana Medical Systems has developed Inform HPV, the first automated, slide-based test for damage caused by the virus. While the dominant HPV test, Digene's Hybrid Capture, measures the amount of virus in a tissue sample, Inform allows lab pathologists to distinguish visually between the HPV cells that have invaded healthy tissue—the primary cause of cervical cancer—and those that are harmless.

Still, Ventana faces an uphill struggle. Since 1999, when the Food & Drug Administration approved Hybrid Capture for HPV testing in women with borderline abnormal Pap tests, Digene has grabbed about 25% of the \$70 million market. On Oct. 2, Digene applied for FDA approval of Hybrid Capture as a primary HPV screen for all women over 30—a potential \$500 million market. Ventana, meanwhile, won't file for FDA approval for at least six months. *Arlene Weintraub*

MAKE A TOXIC SITE BLOOM

THERE'S A GLORIOUS GARDEN GROWING AT A LANDFILL south of Detroit owned by Ford. Tiny lavender monkey flowers, purple and yellow New England asters, and blue-stem prairie grass are thriving between two mounds of refuse blanketed with scrub grass and cattails. But what really has scientists and engineers excited is what's going on underground. Microbes in the soil are receiving nutrients from the roots of these and some 20 other plants and shrubs, helping them to break down complex toxins known as polyaromatic hydrocarbons (PAHs).

If the experiment works as expected, Ford wants to use the same method, called phytoremediation, on a contaminated 30-acre site within its Rouge manufacturing complex that must be cleaned up within five years. So far, the results are encouraging. The soil is contaminated with a carcinogenic hydrocarbon residue—a by-product of the big coke ovens Ford used for decades to process coal. Working with agricultural researchers at Michigan State University, Ford removed some of the poisoned dirt from the Rouge site and used it to create three test plots at the landfill. Now, as the first growing season comes to a close, there's no doubt that the soil is cleaner. While scientists are still analyzing and comparing soil samples taken in May, July, and September, "there is very strong support of the removal of contaminants," says MSU Professor Clayton L. Rugh, who is heading up the project. "The plants are growing very aggressively." *Joann Muller*

GENETIC ADVANCES AGAINST THE PLAGUE AND ANTHRAX

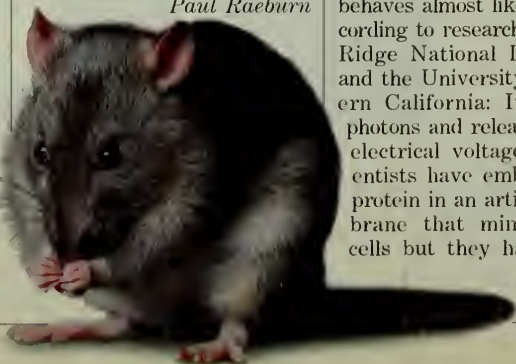
EFFORTS TO DEFEND AGAINST germ warfare are getting a boost from researchers studying two of the most feared weapons in the biological arsenal: bubonic plague and anthrax.

In the Oct. 4 issue of *Nature*, Julian Parkhill and colleagues at the Sanger Centre in Cambridge, England, have decoded the entire genetic blueprint of *Yersinia pestis*, the bacterium that causes plague. There they have found signs of a stormy evolutionary past: lots of gene recombination and decay and many genes apparently absorbed from other bacteria and viruses. The discovery should one day enable researchers to find ways to disable and defend against the plague bacterium, which since the 6th cen-

tury has caused three pandemics that killed 200 million people.

In a separate discovery, researchers at Harvard Medical School report in the October *Current Biology* that they have found a gene that makes mice naturally resistant to anthrax. The discovery could lead to the identification of people unlikely to be infected by anthrax and perhaps provide clues to help others resist infection. The finding may also point to better treatments for an illness that is now often fatal.

Paul Raeburn



INNOVATIONS

■ The Dutch team that crafted the world's first functioning transistor from a single carbon nanotube in 1998 has taken another major step in molecular electronics. In the Oct. 5 issue of *Science*, researchers at Delft University of Technology report that they have deposited multiple nanotube transistors on a silicon chip, connected them with gold wires, and performed rudimentary computer functions. IBM announced a similar breakthrough in August, but the Delft team's chip is the first one to demonstrate that such devices can perform multiple logic operations of the sort carried out by conventional computer circuits. The development is bound to raise the expectations riding on nanotubes—supertough, elongated carbon molecules measuring just 1/100,000th the thickness of a human hair. Semiconductors incorporating such elements would likely deliver huge increases in computing speed.

■ A protein responsible for photosynthesis in spinach leaves might someday be transplanted into human eyes to stave off retinitis pigmentosa, a leading cause of blindness. When this disease strikes, the photoreceptor rods in the retina deteriorate to the point where they can no longer capture light and convert it into electrical signals that the brain interprets as images. In spinach, the protein called Photosystem II behaves almost like a rod, according to researchers at Orange Ridge National Laboratory and the University of Southern California: It captures photons and releases a small electrical voltage. The scientists have embedded the protein in an artificial membrane that mimics living cells but they have yet

start an animal trial.

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HEROES OF THE NEW INTERNET



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LEFT: Guy Tallent, President and CEO, Indentrus

RIGHT: Randy Wilhelm, President and CEO, Thinkronize

*Today, organizations
are truly "trying to
use the Internet as
part of their business."*

—Pam Scanlon,
Executive Director,
Automated Regional Justice
Information System (ARJIS)



iFORCE™ HEROES PROGRAM HEROES OF THE NEW INTERNET

—Kevin Robert Hopkins

To many technology watchers, the year 2001 will long be remembered as the "end of the dot-com dream." In reality, it was merely the end of illusions. Amid the Internet hype of the late 1990s, a great many investors and entrepreneurs seemed convinced that the ordinary laws of economics no longer applied. All too predictably, many such companies failed—not because of some flaw in the Internet, but because of the flaws in well-intentioned but ultimately naïve business models that declared that eyeballs were more important than sales, that market capitalization mattered more than profits.

At last, we're becoming centered again. Suddenly, there is a difference in the ways in which analysts and executives alike are looking at Internet initiatives, with old-fashioned business concepts like purpose and profits once more in vogue. Call it "The New Internet." Pam Scanlon, executive director of San Diego County's Automated Regional Justice Information System (ARJIS) and one of the current Sun Microsystems iForce™ Heroes, notes that, "in the early stages of the Net, people were just throwing things up on the Web with no planning." Now, in the age of the New Internet, organizations are truly "trying to use the Internet as part of their business."

She's absolutely right. Read the stories of the iForce™ Heroes that follow, and it is inescapable how these individuals and the companies they represent have made the Internet, with its real-time network of computers

and information, an essential part of their business. From building new wireless markets to visionary new forms of software, from matching ships with shipping containers to matching lost children with their parents, these iForce™ Heroes have emerged as the vanguard of the New Internet, creating an Internet where the bottom line is just as important as breaking the mold.

It is a pursuit, we are convinced, that a great many other Internet innovators will just as eagerly follow in the years to come.

THE SUN iFORCE™ HEROES PROGRAM

Twice each year, Sun Microsystems pays tribute to the accomplishments of a select group of individuals and companies who are using the Internet in exciting and worthwhile ways. This effort is part of Sun's global iForce™ initiative, established to accelerate customer innovation through the sharing of knowledge and the development of solutions within the Sun iForce™ community which is comprised of Sun, its business partners and customers. The seven iForce Heroes profiled here are among the 18 recognized during Summer 2001. The full roster of current 2001 iForce™ Heroes, along with their detailed stories, can be viewed on the Web at <http://www.sun.com/2001-0829/feature>.

The Human Side of the Internet

few organizations can measure the benefits of its web presence as poignantly as the National Center for Missing and Exploited Children (NCMEC). Whereas commercial firms benchmark their Internet achievements with the boardroom metrics of improved sales and increased brand awareness, the NCMEC denominates its successes in human lives—specifically, the number of desperate families has helped to reunite with their children.

Established in 1984 to serve as a clearinghouse for information about missing children, the NCMEC has played a key role in the search for lost kids since its inception. Under the leadership of its CEO and President, Ernie Allen, the organization—a public/private partnership funded by the U.S. Congress and several private entities—has evolved from a bootstrap phone-based center to a sophisticated international body that works closely with law enforcement agencies throughout the United States and 18 other countries.

But it is the NCMEC's adoption of Internet technologies in recent years that has most enabled the organization to develop into a global network for collecting and supplying potentially life-saving information to law enforcement agencies and the public. Significantly, the Net has cut to mere minutes the time it takes to disseminate information about missing children throughout the world, and that has had a direct impact on the organization's success rate.

"The benefits of the Web have been enormous," says the NCMEC's Allen. "Before, when a child was reported missing, we had to wait for the



"The benefits of the Web have been enormous."

—Ernie Allen, CEO & President, National Center for Missing and Exploited Children (NCMEC)

child's photo and then distribute it, and that could take days. Now, a police department can scan in a photo, send it over online, and we can put it out within minutes."

The NCMEC began employing advanced computer technology in the early 1990s with its use of digital editing procedures that permitted investigators to "age" the photos of children who had disappeared years before. By the end of the decade, the NCMEC had refined its digital technologies to the point that it now supported more than a dozen public web sites, as well as Java™ applets that sit on thousands of other sites, promoting the NCMEC's services.

The consequences of these efforts? Ten years ago, says Allen, the NCMEC's recovery rate for missing children was 60%. Today, that rate has jumped to 93%. "While other factors, such as greater awareness and better law enforcement techniques have made a difference," he says, "there is no question that the single most important factor has been Internet technology."

Delivering Software as a Service

arc Benioff, chairman of Internet pioneer Salesforce.com, a paradox. A veteran of the software industry, he takes his name—and living—predicting the demise of computer software.

When Benioff speaks about the end of software, he's talking about traditional packaged software, with its labor-intensive mechanics of burning applications onto CD-ROMs, distributing them, installing them, and maintaining them—an inordinately expensive and time-consuming process. Using the power of the Internet, Benioff believes, most of this cost and complexity can be eliminated in a single stroke.

Before founding Salesforce, Benioff shepherded Oracle's new technology development, reporting directly to Oracle chairman Larry Ellison. "My job was to look at how to make possible what previously wasn't possible," says Benioff. "I felt that the biggest new opportunity was to use the Internet as a distribution vehicle for enterprise services, enabling customers to quickly log on to a web site and get all the features they'd get from a traditional application, but with much greater ease of use."

After 13 years at Oracle, Benioff was ready to put his theory to the test. He and a dozen colleagues from other companies set out on their own, committed to Benioff's vision of revolutionizing the delivery of software. The new venture, Salesforce.com, was launched in March 1999, and its enterprise subscription service went live with its first users in the fall of the same year.

As its name suggests, Salesforce initially focused on sales force automation, but has since branched out into customer relationship management

(CRM) and marketing automation. The company now offers nine integrated modules—all designed for delivery directly over the Internet. The pricing model is simple: a subscription to the service costs \$65 per month per user. For that, customers receive not only powerful enterprise applications, but also freedom from the burden of having to maintain the applications' IT infrastructure in-house.

The offer has been persuasive. So far, more than 3,000 companies, representing some 50,000 users, have subscribed—making Salesforce one of the fastest growing CRM companies in the world. But Benioff believes this is just the beginning.

The Internet, he says, will truly revolutionize the software industry over the next few years. And Salesforce is proof. The company, he predicts, will "change the world by showing you don't have to buy software to build and run your company."

"You don't have to buy software to build and run your company."

—Marc Benioff, Chairman, Salesforce.com



Making the Mobile Internet a Reality

Many technology watchers automatically equate third-generation wireless with the mobile Internet, but not Mark Dickelman. "3G is dead, or at least on life-support," proclaims the Bank of Montreal vice president for m-commerce & wireless. "While 3G keeps slipping further into the future, the mobile Internet is real and here and working."

Dickelman should know. In the fall of 1999, he spearheaded the launch of Bank of Montreal's Veev, a mobile Internet banking, brokerage, and information service. In seeking to refine its electronic delivery strategy, the bank had boldly decided to focus on the mobile Internet, and had asked Dickelman, who had been involved from the outset in the bank's e-commerce initiatives, to oversee the development and launch of the new channel.

From its web-banking experience, the bank knew that building core technology from the ground up was not a winning approach. It therefore chose to partner with Toronto-based 724 Solutions, whose experience and proven technology, Dickelman was convinced, would enable the bank to reach the marketplace years earlier than otherwise possible. And so, while the traditional wireless industry was spending billions of dollars on licenses for spectrum that, Dickelman believed, had very little hope of being effectively developed, Bank of Montreal was preparing to launch a practical, working service.

And, as it happened, Veev was soon thriving, and has become increasingly popular since its public debut. Now available on six networks across Canada and, in the United States, via Harris Wireless, Veev supports almost

"The mobile Internet is real and here and working."

—Mark Dickelman, Vice President,
M-commerce & Wireless, Bank of Montreal



every make and model of cell phone, as well as RIM Blackberry and Palm devices. Customers have access to real-time banking and brokerage services, market information, stock-price alerts, links to news, a clipping service, weather, horoscopes, shopping, and air-mile account management.

"Getting Veev off the ground was a challenge," Dickelman admits. "V started off with the only 500 browser-enabled phones on the planet—clunky devices that people didn't like—and just a single network. We had no idea how far ahead of the market we were. It was more than a year before any of our competitors joined us in this market in Canada."

And while mobile Internet services do not yet constitute a mass market, Dickelman believes that they are quickly headed toward the mainstream. "Availability, which is the single most important factor in adoption, improving rapidly." Already, "it's getting hard to buy a cell phone that doesn't have a browser. Three years from now," he predicts, "it will be impossible."

Where Content is Still King

Just as they have in North America and Europe, wireless solutions and the mobile Internet have experienced a roller-coaster of fortunes in Asia as well. It has taken companies like Japan's DoCoMo, a subsidiary of Japanese telecommunications giant NTT, to add some stability to the enterprise. Over the past two years, through its i-mode service, DoCoMo has done more than build a successful business: it has vividly demonstrated that the mobile Internet can work.

DoCoMo launched i-mode in February 1999, and the service proved an instant hit. For Japanese teenagers, i-mode handsets quickly became a "must have" accessory, but clever marketing attracted adult subscribers as well. And while Americans and Europeans with WAP phones and Palm Pilots needed a dial-up connection, their Japanese counterparts did not: from the start, the i-mode service was "always on."

So successful has the i-mode venture been, in fact, that i-mode subscribers now number more than 26 million.

For Kei-ichi Enoki, Managing Director for i-mode, DoCoMo's success stems from a different concept of the Internet. "The idea of accessing the Internet from a mobile device was not new," he explains. "But we are

the first company in the world to have shown that, by creating a distribution platform for content specially adapted for use on mobile phones, we could build and expand our business."

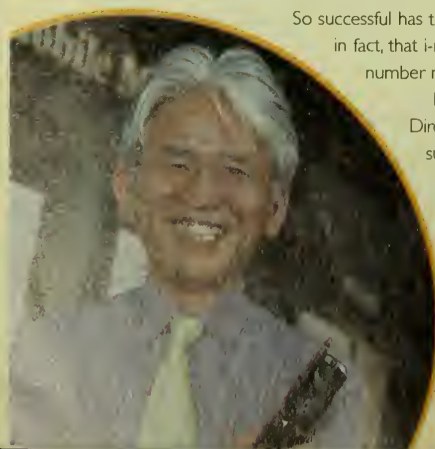
Indeed, for DoCoMo, content has been key. Currently, i-mode provides access to 1,800 custom web sites and 47,000 mainstream Internet sites. But what is most crucial is the way in which the content is packaged.

"PCs are like department stores," says Enoki. "They have a wide selection of content, including excellent graphic images. If you decide to make a visit, you can stay as long as you like and explore different sites at your leisure." By contrast, "mobile phones are more like convenience stores where only a selection of goods are on display in the limited space available. The contents have to be simple, but the convenience comes from the fact that they can be accessed at any time."

Still, DoCoMo is not stopping with its successful "convenience store" approach to content. Last May, the company unveiled its first broadband-content prototype, which Enoki believes will help expand i-mode's appeal far beyond Japan. "i-mode is not specific to Japanese culture," he says. "If you understand the concept of i-mode and the ways of developing business, you can succeed anywhere."

"If you understand the concept of i-mode, you can succeed anywhere."

—Kei-ichi Enoki,
Managing Director, i-mode, NTT DoCoMo



The Internet will allow the police to be more proactive."

—Pam Scanlon

Executive Director, Automated Regional Justice Information System (ARJIS)

Fighting Crime in Real-Time

San Diego County's 10,000 police officers owe a lot to Pam Scanlon. Until three years ago, every time they wanted to check a suspected criminal's photo or look up a driver's license, police officers had to drive back to their precinct building through the area's increasingly heavy traffic and slog through up to 32 different data screens to find the information they were seeking.

Now, they can do their work directly from a laptop computer stationed in their squad cars. Thanks to a computer program nicknamed "Yahoo Cops," San Diego police officers can simultaneously search the databases of 38 different state and federal government agencies—from the local sheriff's office to the FBI—and retrieve the information they need in seconds.

Their system, formally known as Infotech, got its start in the mid-1990s when Scanlon, the executive director of the County's Automated Regional Justice Information System (ARJIS), realized that emerging Internet technologies could "give both citizens and the police the most accurate and timely information" possible. But in order to make her vision a reality, she had to win the support of ARJIS's 38 members—no small feat in a sector with a traditionally conservative approach to IT.

And so Scanlon decided to proceed in small steps. First, she set up a linked web sites (nicknamed "Cagney" and "Lacey" after the TV series)

providing a core of crime information to the public and the police. Next, she added a crime-mapping application to feed nearly real-time information into the web sites, updating all crime incidents every 24 hours and emergency services calls every 15 minutes.

Finally came two of the program's most powerful applications—a database of "booking" photos of suspected criminals that police could access from their web browser and a global query system that allowed officers to remotely extract critical information from the County's aging mainframe computers.

So successful has the ARJIS system been that two neighboring counties, Los Angeles and Imperial, are considering joining ARJIS. But Scanlon is not resting on her achievements. Her next goals: to link police force radio and voice networks into the system, and to overlay other local databases, like community planning data, to give police a more complete picture of a community's needs. "At the moment, we have islands of data," she explains. Piecing this information together, "the Internet will allow the police to be more proactive"—one of the most effective steps yet in the fight against crime.

With networked sales, we can preserve "information with a high strategic value."

—Henry Visconde, CEO, Sydeco

A Mobile Sales Infrastructure

Brazil's pharmaceutical industry has grown increasingly sophisticated in recent years, but one area in which it has lagged behind its global counterparts is in the use of mobile computing. In fact, until a few years ago, computers were almost non-existent among the industry's field sales forces. Henry Visconde decided to change that.

Visconde is CEO of Sydeco, the IT arm of Laboratório Biosintética, one of Brazil's leading pharmaceutical companies. Historically, Laboratório Biosintética employed a field sales staff of 150 to sell its products to doctors and hospitals, with each salesperson making an average of 12 visits a day. The information they gained in these encounters was invaluable to the company. The problem was, it could take weeks for the salespeople's paper records to make their way into the company's central database.

"We needed to bring the sales force closer to the company," Visconde recalls. His solution: provide each salesperson with a wireless link to the company's central network. Unfortunately, at the time, Laboratório Biosintética possessed none of the technical infrastructure needed to support such a change. For instance, none of the salespeople had a PC with a modem or any form of mobile computing device.

Visconde realized that, in these circumstances, if his approach were to succeed, he would have to work closely with the field sales staff in designing and implementing the proposed system. He therefore invited ten

salespeople to test the company's initial prototype. While the salespeople found the experience rewarding, they suggested a number of refinements to make the system easier to use. As a result of their comments, says Visconde, "we changed our prototype almost completely."

The result? Within a few months, not only was the new system in place, but the salespeople had become so confident in its reliability that they had begun destroying their paper records, choosing to rely completely on the electronic versions.

Both sides gained in the process. The sales force now had a fast online link to the company's central records—a key source of intelligence for increasing sales. And Laboratório Biosintética's nearly instant access to field information gave it a huge strategic advantage in the marketplace, even while saving the company \$120,000 in annual operational costs.

But the greatest gain, says Visconde, was in continuity. "Previously, when a salesperson left the company, he took the information about the history of his customer relationships with him. Now, the company has that information in a database—information with a high strategic value."



Turning Shipping Ports into Data Ports

For Robert Yap, then a young software engineer, the siren call of high-tech Singapore proved irresistible. Passionate about information technology and looking for a change, he left Australia and soon found the perfect berth—PSA Corporation. "I joined PSA because it really believes in technology and has a strong vision to expand globally," says Yap, "and I felt that I could contribute in a small way to its expansion."

Ignore the modesty. The fact is, Yap has been a primary driving force behind the creation of one of the most technologically sophisticated port operations on the planet.

Formed in 1997 after 33 years as the Port of Singapore Authority, PSA Corporation Ltd. is the world's largest shipping hub, have developed unmatched expertise in global port operations and logistics. Portnet™.com, a wholly owned subsidiary launched in May 2000, spearheads PSA's e-commerce initiatives, with the goal of helping the entire shipping and port community increase productivity and cut costs through the greater use of information technology.

The Portnet™ infrastructure has been evolving since 1984, and now has more than 7,000 users who conduct nearly 70 million transactions each year. Originally, Portnet™ relied on mainframe computers to link Singapore's shipping lines to government agencies for customs clearances, trade declarations, and the like. Now, as an Internet-based operation, says Yap, Portnet™ has "come of age." Not only does the information flow through the system much more quickly, but Portnet™'s role has greatly expanded, becoming the e-commerce backbone of a global Internet-based maritime community.

A key Portnet™ innovation is eMart, a recently created e-marketplace that allows shippers, among other things, to address the problem of repositioning millions of empty shipping containers in order to better manage their assets. Using eMart, shippers can quickly check the availability, volume, and location of up to 17 million empty containers to see if they can be shared or re-used, greatly increasing the port's operational efficiency.

Even in its early stages, eMart's potential has won global attention. "We're getting requests and expressions of interest from port communities worldwide that are serious about using the Internet to increase efficiency in information management and procurement," says Yap. "So we're trying to scale up as quickly as possible to respond to those market demands. It's a good problem to have."

CONCLUSION: QUALITY AND RELIABILITY

One of the most significant commonalities among the 2001 class of Sun's iForce™ Heroes is their reliance on Sun software, hardware, and services as the technological foundation of their path-breaking Internet initiatives. Their choice of Sun was more than a happy coincidence.

Mark Dickelman of the Bank of Montreal, for one, decided early on to move his bank's wireless operations from Windows NT to the Sun Solaris platform. "Sun has focused on delivering really world-class scalable server solutions, and has done some of the earliest and broadest thinking about

how to make mobile Internet technologies work," he says. "In my opinion, none of Sun's competitors has had the same level of focus." Similarly, Pam Scanlon of San Diego's ARJIS reports that her organization chose Sun because of the performance of its products, and "with 10,000 police office using our system, a high level of performance was vital."

Other organizations have relied on the power and flexibility offered by Sun software, particularly Java™ technology. For example, all of the applications created by the National Center for Missing and Exploited Children, says CEO Ernie Allen, are Java™ technology based, a standard that enables a wide range of law enforcement agencies and private citizens to access the organization's web sites. Likewise, since late 1999, Japan's DoCoMo has been working with Sun to enrich the DoCoMo browser with Java™ technology because of Java™'s ability to make dynamic the content that is so central to DoCoMo's value proposition. And Brazil's Sydeco developed its sales system using Java™ technology, enabling the company to quickly create a prototype and easily adapt it as the company learned more about its salespeople's needs.

But perhaps Mark Benioff, the chairman of Salesforce.com, best summarizes the reasons that this year's iForce™ Heroes have relied so heavily on Sun technology and services. "We chose Sun" as the core of Salesforce's infrastructure, he says, "because we knew it would be able to deliver the kind of quality and reliability we needed." In a world where Internet-based solutions are being viewed with an ever more probing eye that kind of quality and reliability are proving essential in building "The New Internet" and in delivering the bottom-line benefits that are transforming the Internet, at last, from its roots as a technological curiosity into an increasingly vital centerpiece of everyday business operations.

"Port communities worldwide are serious about using the Internet to increase efficiency."

—Robert Yap,
Executive
Vice-president
for Information
Technology, PSA
Corporation Ltd. and
Managing Director,
Portnet™.com Pte Ltd.



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JUST WHEN IT SEEMED ON THE MEND...

Cendant has slumped since September 11, as travel wanes

For a while this year, it seemed almost like the good old days for Henry R. Silverman. The 61-year-old chairman and CEO of travel-

real-estate giant Cendant Corp. finally had put a devastating accounting scandal behind him. He was striking a series of high-profile deals. And his company's stock price had enjoyed a nice run-up, going from \$9.63 in January to \$21.53 in July. Then came September 11. Silverman's dealmaking had focused on expanding the travel empire that includes franchised Days Inns, Howard Johnsons, and other hotels; the Avis rental-car company; time-share properties; and an Internet travel portal. The hijackings of commercial jets, however, sent the travel industry to a tailspin and probably put the economy into recession. Travel businesses normally provide half the revenues of New York-based Cendant—the airlines and highways aren't delivering the usual number of customers to the company's rental-car counters and hotels. A couple of days after the attack, Cendant had 35 people signed

to see a time-share in Williamsburg, Va. Only one showed up. Already, Silverman has said he will cut Avis' and lay off 20% of its staff. The turmoil has sent the stock price on a sickening slide, to as low as \$11.03 before rebounding to a recent \$12.18. That's bad, but it gets worse. The weak stock price threatens Silverman's strategy for fueling

growth: making more and more acquisitions, increasingly financed with stock. Cendant's core businesses usually generate revenue growth of 6% to 8% and earnings growth in the low teens, according to J.P. Morgan Securities Inc. analyst Amanda Tepper. That's decent. But investors had been betting that Silverman's prowess with

deals would generate much faster growth. After all, between 1992 and 1997, rapid-fire dealmaking drove earnings up 63% a year at HFS Inc., the company Silverman founded and then merged with CUC International Inc. to form Cendant. "Henry is trying to recreate the aura of the old HFS, and to do that he has to do deals," says Gregory L. Jackson, an analyst at Cendant investor Harris Associates. The slide in Cendant's stock price "makes his life more difficult," he says.

"WE'LL REV UP." Silverman acknowledges that the attacks have derailed his merger machine for now. He says Cendant needs to be more cautious than ever about maintaining its liquidity. And he is in no rush to go bargain hunting. "We'll be patient and wait until there is some stability and return to normalcy," Silverman promises. But when that happens, "we'll rev up the motors again."

The extent of Cendant's difficulties became clear on Sept. 28. Silverman warned Wall Street that Cendant would not meet third- and fourth-quarter earnings projections, saying the company now expects to earn 15¢ to 19¢ a share in the fourth quarter instead of 24¢. Silverman also said that 2002 wouldn't meet expectations but that the company would aggressively cut costs to keep earnings from falling even more. Jolson Merchant Partners analyst James F. Wilson now expects Cendant's sales to rise 76% this year, to \$8.3 billion, instead of \$8.9 billion, while income will climb 59%, to \$958 million, instead of nearly \$1.1 billion. The big increases are largely due to acquisitions. For 2002, Wilson figures that sales will climb 14%, to \$9.4 billion, instead of \$11.2 billion, while income will climb 32%, to \$1.3 billion, instead of \$1.6 billion.

Certainly, not all the news is grim. Cendant's real estate operations, which include a large mortgage company and the franchise rights to brands such as Century 21, should hold up as interest rates continue to

CENDANT'S EMPIRE IS WOUNDED ...

VEHICLE SERVICES

*\$3.1 billion sales**

Avis rental-car business is under pressure as companies curtail travel.

Cendant also owns PHH Arval, a fleet-leasing operation.

AVIS

HOSPITALITY

\$1.8 billion sales

Travel-related industries are suffering. Cendant franchises hotel chains such as Ramada and Days Inn. It recently bought global reservation system Galileo International and is buying online travel agency Cheap Tickets.

DAYS INN

...BUT STILL BOASTS STRENGTHS

REAL ESTATE

\$1.7 billion sales

Home sales may weaken a bit, but bad news for Century 21, Coldwell Banker, and ERA. But its large mortgage operation should grow, as low rates spur more refinancings.

Century 21

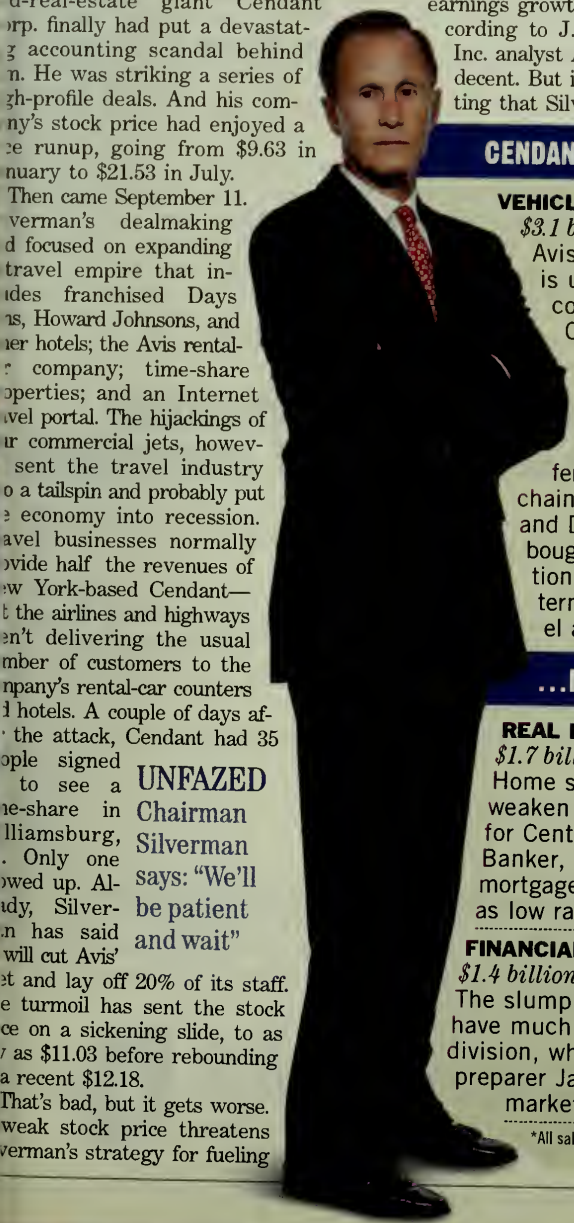
FINANCIAL SERVICES

\$1.4 billion sales

The slump isn't expected to have much impact on this division, which franchises tax preparer Jackson Hewitt and owns marketer FISI-Madison Financial.

JACKSON HEWITT

*All sales estimates are for 2001. Data: Jolson Merchant Partners



The Corporation

fall. At the same time, Silverman's franchised hotel chains are mostly in the budget category, which is likely to take less of a hit than high-end properties as the economy weakens. And if travel stabilizes, the company may be able to use its healthy cash position to prime the deal machine. (It has \$2.8 billion in cash and cash equivalents on its balance sheet and businesses that generate about \$1.8 billion a year in free cash flow.)

Many of the travel businesses that Silverman may have his eye on, including another rental-car operation, should be cheaper now. "There will be a [buying] opportunity for people with a strong balance sheet," says Michael A. Leven, chairman and CEO of U.S. Franchise Systems Inc., a competitor that franchises brands such as Hawthorn Suites, a lodging chain.

Despite the turmoil, Silverman shows no sign of backing off from his effort to create a travel powerhouse. In the past year, he has gobbled up time-share operator Fairfield Communities Inc. for \$690 million and global-reservation-sys-

NO FRILLS
Cendant's chains may do better than upscale brands



tem operator Galileo International Inc. for \$1.8 billion, a deal that closed on Oct. 1. The \$280 million acquisition of online discount travel agency Cheap Tickets Inc. is pending. Galileo, whose reservation network is second only to Sabre Inc., provides airline, hotel, and rental-car booking services to some 43,000 travel agencies and other subscribers. That network could feed business to Silverman's 500,000 hotel rooms and to Avis, as well as to his time-share operation. At the same time, Galileo's Internet travel por-

tal, Trip.com, will be the center of a major effort to build an online operation.

PLAYING CATCH-UP. It isn't clear, however, that Cendant will be a winner on the Web anytime soon. Henry H. Hartevelt, a senior analyst at Forrester Research Inc., warns that Cendant's budget-oriented hotel brands might not appeal to the travelers who book hotels online; they tend to be better-heeled and stay in more upscale accommodations. And he points out that the time-share market has generated little online interest, with ju-

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The whole world owes America a huge debt of gratitude for the willingness and determination of U.S. citizens to repeatedly risk their lives to ensure that freedom prevails. As I watched the televised opening of the New York Stock Exchange last Monday, as I saw the heroic firemen and policemen ring the opening bell, I was deeply moved by the unbroken power, strength and determination of this great country. One thing is clear. Each of us – in our own way – must work to ensure that the good, the right and the just will prevail in the end.

Excerpts from address by Dr. Heinrich v. Pierer, recipient of the Appeal of Conscience Award, Monday, September 24, 2001. Dr. v. Pierer is President and Chief Executive Officer of Siemens AG.

Founded in 1965, the Appeal of Conscience Foundation has worked on behalf of religious freedom and human rights throughout the world. This interfaith coalition of business and religious leaders promotes mutual understanding, peace and tolerance. The Foundation believes that freedom, democracy and human rights are the fundamental values that give nations of the world their best hope for peace, security and shared prosperity.

If you would like to read Dr. v. Pierer's speech in its entirety, visit www.siemens-usa.com
To learn more about the Appeal of Conscience Foundation, visit www.appealofconscience.org

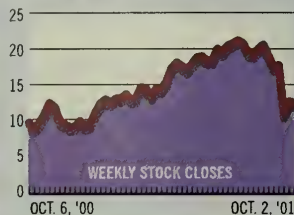
The Corporation

1.6% of travelers booking a time-share reservation over the Internet in the past 12 months. At the same time, Cendant must play catch-up with established Internet players such as Expedia Inc. and Travelocity.com Inc., as well as with the airline-backed travel agency Orbitz. But Silverman contends that combining Trip.com and Cheap Tickets with his existing travel properties immediately gives Cendant a formidable Web presence. And he expects to make deals to sell excess inventory for other travel providers, including airlines and other hotel chains.

The promise of all this dealmaking is that somehow Cendant will tap a bonanza of cross-marketing. That strategy was central to the ill-fated HFS and CUC merger in 1997 that formed Cendant. Silverman, who had spent years as a dealmaker at Reliance Group Holdings Inc. and Blackstone Group, had earned HFS a wide following on Wall Street with a steady stream of acquisitions that sharply boost-

ed earnings. In merging with CUC, the goal was to feed the huge HFS customer base into CUC's direct-marketing machine, which sold memberships in discount buying clubs such as Travelers Advantage. That effort crumbled when massive accounting irregularities were found at the businesses of the former CUC.

A SUDDEN SETBACK FOR CENDANT'S RECOVERY



Data: Bloomberg Financial Markets

The scandal obliterated much of Cendant's market capitalization and with it Silverman's reputation as a modern-day Midas. Silverman has sold virtually all of CUC's businesses. Walter A. Forbes, founder of CUC and former chairman of Cendant, was indicted on conspiracy and wire-fraud charges and has pleaded not guilty.

Although shaken by the CUC debacle, Silverman remains determined to make the cross-marketing strategy work. He has shown he can do it in the real estate business, where more than 20% of the company's mortgage-origination business comes from its franchised real-estate offices. With travel, for example, Cheap

Tickets will switch from the Sabre reservation system to Galileo. Trip.com and Galileo also could help move hotel room or rental cars at a discount when business is slow. Still, some investors aren't convinced that Silverman can squeeze a lot more out of cross-selling. "That would be wonderful, but it is easier said than done," says Monica Logani, a senior investment analyst at Cendant shareholder Federated Investors. "I take it with a grain of salt."

First, however, Silverman will have to weather the storm in the travel business. And no one is predicting how long that will last. "You're looking at a window covered with black paint at the moment," says Barry S. Sternlicht, chairman and CEO of Starwood Hotels & Resorts Worldwide, which owns Sheraton, Westin, and other brands. It looks as if Silverman's bid to regain the luster of his old HFS days may take longer than he hoped.

By Amy Barrett in Philadelphia
with Diane Brady in New York

BusinessWeek online

For an investor's view of Cendant, go to the Oct. 10 Daily Briefing at www.businessweek.com/today.htm



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INTEL

Intel Corp. Chief Executive Craig R. Barrett gulps down an orange soda. After folding his 6-foot, 2-inch frame into a chair in a cramped conference room, it's clear he is uncomfortable with more than the tight quarters. The topic of discussion is his legacy—or what it will be. Halfway through his tenure as Intel's fourth CEO, the 62-year-old Barrett has three more years until he hits mandatory retirement age. Emblazoned on the awards, plaques, and framed articles crowding the walls, the accomplishments of Barrett's predecessors are daunting reminders of the short time he has left to satisfy his own ambitious goal of reinventing Intel.

Here, more than anywhere else, the word "legacy" smothers Barrett. The mementoes around the room mark the legendary work of Chairman Andrew S. Grove, the Midas of microprocessors who, practically by force of will and a vision of the rapid growth of the personal computer, shaped Intel into one of the world's most powerful technology companies. Grove replaced Gordon E. Moore, the technical genius who set in motion what became codified as Moore's Law: that processor performance will double every 18

Cover Story

months, getting cheaper along the way. Before Moore came Robert N. Noyce, an Intel founder who co-invented the integrated circuit, paving the way for countless technological advances that

have formed the bedrock of the computer industry. And Barrett's legacy? "My legacy is not to be the trivia question 'Who was the fourth CEO at Intel?'" he says. "I hope not to be 'I don't know, who was it?'"

There's no doubt Barrett is having a hard time earning his place on the wall. After launching a bold strategy three years ago to move Intel beyond PCs and into such markets as communications, information appliances, and Internet services, the chipmaker is in its worst shape in more than 15 years. Oh sure, there isn't a tech exec on the planet who isn't having a crummy year because of a souring economy and the threat of war in the wake of the terrorist attacks. But Intel's problems run deeper than these events. For the past three years, Intel has seesawed between product shortages and product delays in its core computer-chip business. Piled on top of that have been embarrassing bugs, recalls, and overpriced processors that opened the door for rivals. By yearend, analysts expect Intel's share of the PC chip market to drop to 78%—nine percentage points below what it had when Barrett took over.

Barrett's invasion into new markets has been even more dismal. So far, some \$4 bil-

PHOTOGRAPH BY ERIC MILLETTE. CHART BY ERIC HOFFMANN/BW

CAN CEO CRAIG BARRETT REVERSE THIS

SLIDE?



"WE'VE GOT THE
TECHNOLOGY, WE'VE
GOT THE STRATEGY"

lion of Intel's more than \$10 billion in new investments have produced little. This year, Intel stopped making network servers and routers after some of its biggest chip customers, including Dell Computer Corp. and Cisco Systems Inc., slapped Barrett's hands for competing against them. In February, Barrett shut down a service for broadcasting shareholder meetings and training sessions over the Web. He shuttered iCat, an e-commerce and hosting service for small and midsize businesses. And he has retreated so far in the information-appliance business that Intel now markets its Web-surfing devices only in Spain. "Certainly, Craig's vision looked a lot more attractive a year and a half, two years ago," sighs board member David B. Yoffie, a professor at Harvard Business School.

EARNINGS DROP. What went wrong? Critics say Barrett has been trying to move Intel into too many new markets, fracturing the company's focus on its core business. To execute on so many fronts, he has decentralized the organization and delegated a lot of decision-making. But getting a workable structure in place has been a challenge. Barrett has restructured the business groups at least three times in as many years, shuffling execs like cards in a deck. Even in the core microprocessor group, a startling 80% of the unit's staff were given new roles in a March shakeup. "Typically, people moving around a lot are not sure where they are going," says one longtime customer. Adds G. Carl Everett Jr., a former general manager of Intel's Desktop Products group, who left the company in 1996: "They're dabbling in everything and overwhelming nothing."

Now, Intel is bracing for its worst financial results since it fled the memory-chip business in 1985. Sure, the entire semiconductor industry is in its worst slump in a decade, suffering from overcapacity and weak demand that will cause global chip sales to tumble 34% this year, according to researcher IC Insights. But Intel will take a bigger hit, because it has failed so far to wean itself from dependence on a slowing PC business. Intel's revenue is expected to decline 52%, from \$33.7 billion in 2000 to \$25.5 billion this year—the chipmaker's first revenue

BARRETT'S BIG BETS

MANUFACTURING

Spending \$7.5 billion to convert plants worldwide to the latest technologies in a bid to make chips at costs below rivals.

BENEFITS New factories will use larger, 12-inch wafers that pack in more circuits, copper wiring for faster speeds, and ultra-efficient production equipment to slash per-processor manufacturing costs as much as 50%.

CHALLENGES Balancing manufacturing for a variety of chip lines, while preventing technical glitches. Prolonged downturn could mean the company bet on an expensive transition at the wrong time.



HIGH-END SERVERS

McKinley, the next Itanium server processor expected to handle information in large chunks, is scheduled to begin rolling out in early 2001, doubling performance and lowering power requirements.

BENEFITS Shows most promise for juicy profit margins, with high-end server chips estimated to bring in between \$1,200 and \$4,000 per processor. That's crucial for making up for the slimmer margins on Intel's high-volume Pentium 4 chips, which sell for \$133 and \$562.

CHALLENGES The \$2 billion Itanium effort is two years behind schedule, giving rivals AMD and IBM time to match Intel's offerings. Critics say Intel missed its chance now that a economy has cut into server sales

you're going to have to prove to me that they're crawling on all fours before I replace them." On Oct. 1, Merrill Lynch cut its fourth-quarter revenue estimate for Intel by 2%, to \$6.15 billion.

It's now unlikely Barrett will reach his goal of 20% revenue growth in the overall business next year. For fiscal 2002, Merrill Lynch figures Intel's revenues will rise only 13%, to \$28.8 billion, while net income is expected to rebound 147%, to \$1.9 billion. Next year's profit growth sounds good, save the fact it will be Intel's third-worst showing since 1986. Barrett made his growth predictions before September 11, and even though he

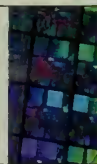
has not revised his goals, he is hinting at more job cuts. So far this year, he has cut 5,000 jobs through attrition, bringing the workforce to 80,000. In a Sept. 26 speech

to employees, the CEO pointed out that Intel's head count is 20,000 employees higher than it was two years ago, even though revenues are the same. The message wasn't lost on his audience, nor on his shareholders. Before the terrorist attack, Intel's stock was hovering at \$26—more than 60% off its 52-week high. Today, the stock is around \$20, amid fears that shaken consumer confidence will hurt PC sales. Says a top executive at a major PC maker: "I have never seen them at a weaker moment in the history of Intel."

That's raising questions about Barrett's leadership. No one is calling for him to step down, but a chorus of former ex-

So far, \$4 billion of Intel's \$10 BILLION in new investments has produced little

drop since the 1985-86 tech recession. Profits are falling off a cliff, too, plummeting from \$10.5 billion in 2000 to \$773 million this year, estimates Merrill Lynch & Co. And it's likely to get worse. In the week following the September 11 attack, UBS Warburg analyst Don Young says retail PC sales tanked 50% year-over-year at a time when most were expecting a pickup in demand. And the news from corporate America isn't any better. Consider Frank J. Fanzilli Jr., Chief Information Officer of Credit Suisse First Boston, and what he has to say about buying new PCs under current economic conditions: "I will only be looking to replace PCs that are really crawling, and



*disastrous forays into making everything from Internet routers to information
ances, Barrett has settled on what Intel does best—silicon chips*

LESS

play: wireless Internet on a
nounced in May, the chip
s all the previously separate
needed to build handheld
or cell phones.

ITS Intel has an advantage
one-stop shop, offering
nts for quickly getting new
ts such as cellular phones and
al digital assistants to market.

CHALLENGES Getting top
icturers such as Nokia,
n, Motorola, and Palm to
from established suppliers
; Texas Instruments and
ed Micro Devices.



COMMUNICATIONS

Moving into chips, chipsets, and
equipment for ethernet and optical
networking for large phone carriers,
home networking, and voice-over-
Internet technologies.

BENEFITS Few established suppliers
means the field is wide open when
the telecom recession ends and
companies begin buying next-genera-
tion broadband gear. The \$1.2 billion
acquisition of Giga, a maker of chips
for fiber-optic switches, has produced
solid sales so far.

CHALLENGES Intel may have a tough
time keeping up with the rapid pace of
change in the ethernet and optical
space—not its core market.

WEB HOSTING

Intel hopes to dominate this market
for setting up, testing, and managing
Web sites when e-commerce begins
to boom again.

BENEFITS Small and mid-tier busi-
nesses increasingly want a third party
to host and manage their Web site. In-
tel is hoping to crack this market that
is now stalled but expected to boom
again. Forrester Research predicts the
overall business will hit \$14 billion by
2004, up from \$4 billion in 2000.

CHALLENGES Intel has yet to make
any profit on the business, after
announcing it would invest nearly
\$2 billion to build data centers around
the globe. As other Web hosters flame
out, Barrett says he'll stay the course,
although he's cutting back funding.



atives, analysts, customers, and partners say Grove should
turn as Intel's big strategic thinker. For years, Grove and
rrett had been the chip industry's dynamic duo—Grove was
e visionary and Barrett was the nuts-and-bolts operations
ef. "They complemented each other. In the old days, Andy
s like Batman, and Craig was Robin," says one former top
ecutive. "But everyone knows, when you want to figure out
w to beat the bad guy, you don't call Robin."

Yet Grove's booming voice is heard less and less fre-
quently at company headquarters. As chairman, he remains a
ce at Intel, but he says his role is mostly as an observer
en it comes to decision-making. Always a cautious, me-
dical planner, Grove says he has been uncomfortable with
rrett's bold actions, but he defends the current CEO. "If he
s equally as cautious, we would be destined to remain a
he player," Grove says. Still, Grove notes that he sought
advice of Gordon Moore during his early years as boss far
re frequently than Barrett seeks him out. Barrett "march-
to his own drummer," Grove says. "It's not that he doesn't
e advice, he doesn't depend on it."

NOT GUILTY. Indeed, Barrett isn't the least chastened by In-
tel's flagging performance or criticism of his many-pronged
ategy. With a temper at times as prickly as the cactus tow-
ng over his 9-by-9 cubicle, Barrett says his strategy has not
eated a company without focus. "Guilty as charged, we
l product screwups," he says curtly. "Not guilty as charged
t we can't do more than one thing at a time." The product
ortages, bugs, and recalls, he says, were "side effects" of
shing forward into many markets at a breakneck pace.

Microsoft Corp. Chairman William H. Gates III, who also
steered his giant software company into new turf while build-
ing his core Windows business, agrees. "You can't do this
without sometimes hitting a bump in the road," says Gates.
"But Intel is making a lot of smart bets on the future."

Barrett says he's not backing off those bets. Three years
ago, he vowed to branch out into communications, info appli-
ances, and Internet services. His original vision not only called
for making chips for networking gear, cell phones, and handheld
computers but also for churning out Intel hardware—network
servers, Web-surfing devices, and routers to guide data over
networks. At the same time, Barrett tried to build a services
business, with Intel
running e-commerce
operations for others
or dishing up business

software to corporate customers over the Net. The full scope of
his vision has been far from realized. Intel has retreated from
most of the Intel-branded product offerings to rely on what In-
tel knows best—making chips. Now, his beyond-the-PC plans
translate into producing tiny slivers of silicon to go into wire-
less and other communications products.

Intel's problems, Barrett says, are largely the result of the
economic downturn. Still, he maintains, he's turning that to his
advantage by plowing gobs of money into research and man-
ufacturing advances—\$11.5 billion, a staggering 45% of rev-
enues—at a time when rivals can ill afford such lavish spend-
ing. That's classic Intel, a ploy Grove used against
cash-strapped microprocessor rivals to widen his lead in the

Cover Story

mid-1980s. With a \$10 billion cash reserve and a seasoned team, Barrett says Intel is positioning itself to come out of the downturn in better shape than rivals both old and new. The downturn, he argues, is giving Intel time to hone its next-generation products in all the markets he has targeted. "We've got the technology, we've got the strategy," he says.

That may not be enough. Now more than ever, flawless execution in Intel's core microprocessor business is essential to overcome weak results in the new businesses and the plunge in the economy. Rival Advanced Micro Devices, however, hopes to throw a monkey wrench into that plan. The scrappy upstart, locked in a bitter battle with Intel, has made major inroads since 1999, when it introduced its Athlon processor. The chip, which was faster than Intel's Pentium III, was quickly snapped up by PC makers, especially when Intel couldn't make enough processors to meet sizzling demand during the Internet heyday. AMD, after nearly two decades, finally put a dent in Intel's market share.

NO SWEAT. This year, Intel counterpunched. It slashed prices on its Pentium 4 chips by 84%, dragging AMD into a savage price war. And in the past month, Intel has released a speedy, 2-gigahertz Pentium 4 chip that outguns AMD's top processor. AMD is expected to strike back by mid-October with faster Athlon chips. But Barrett isn't sweating it. "Our Pentium processors are coming out ahead of schedule. Our chipsets are coming out ahead of schedule. Our whole road map is accelerating," he crows.

The only problem is, the PC market isn't traveling at the same

Cover Story

speed. This year, for the first time, PC sales are expected to decline. Even when the economy crawls back, few expect buyers will return to their habits of the past, when ever more powerful PCs were a must-have. Increasingly, customers are more dazzled by the speed of their Internet connections than by the speed of their PCs. Intel has been getting that message since January, as its chips sped to lofty new heights but sales slumped. Indeed, the average life span of a corporate PC is expected to rise to four years by 2004, from 3.3 years in 1999, according to researcher Gartner Inc. And the percentage of U.S. homes with PCs has been stalled at 58% for the past two years. "Consumers want to know what's in it for them, not just 'This is a bigger number, so it's better,'" says Larry Mondry, chief operating officer of retailer CompUSA.

Barrett shouldn't expect help from his scramble into powerful, high-margin chips for servers either. Selling for up to 40 times the price of a PC chip, analysts say Intel's new Itanium server processors will take at least five years to gain traction. Customers will need to test each new chip and rewrite soft-



PAUL OTELLINI

AGE 50

EXECUTIVE VICE-PRESIDENT Intel Architecture Group

CHALLENGE As heir apparent, the 27-year Intel vet must meet Barrett's goal of double-digit annual growth in the core microprocessor business

ware to take advantage of processing in massive 64-bit chunks instead of the more common 32 bits. That's painful news for Barrett, considering Intel has staked so much on Itanium—a joint project with Hewlett-Packard Co. that took seven years and \$2 billion yet came to market two years late, missing the tech buying boom. This year, says IDC analyst Steve Joslin, sales of Intel-based servers will decline nearly 10%, to \$23 billion, from \$25.3 billion a year ago, com-

pared with a modest 3% decline in the competing Unix server market. After the terrorist attacks, Joslin revised his 2002 projections downward from 9% growth to a 1% decline. "It's not pretty out there now," he says.

And the new businesses won't be much help any time soon. In three years, Barrett has pumped more than \$1 billion into 34 acquisitions to bolster efforts in new markets, betting that those deals would help such units as the Communications Group and the Wireless Communications & Com-

BARRETT'S TUMULTUOUS TENURE

Since becoming CEO in March, 1998, Barrett has moved aggressively to reinvent the giant chipmaker. But false starts in new businesses, technical troubles, and management missteps have caused the overall business to head south

TO REGAIN LOST MARKET SHARE...

WORLDWIDE PC SHIPMENTS		
	INTEL	AMD
1998	86.7%	6.6%
1999	80.9	14.1
2000	83.1	16.7
2001*	77.6	22.1

*YEAR-TO-DATE

Data: IDC

...INTEL LAUNCHED AN AGGRESSIVE PRICE WAR...



▲ DOLLARS

Data: Lehman Brothers Inc.

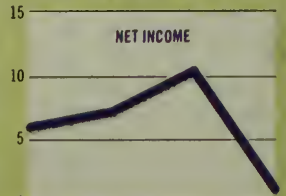
...BUT THAT HAS CUT INTO THE TOP LINE...



▲ BILLIONS OF DOLLARS

Data: Intel Corp., Merrill Lynch & Co.

...AND CLOBBERED THE BOTTOM LINE



▲ BILLIONS OF DOLLARS

Data: Intel, Merrill Lynch & Co.

ing Group grow 50% annually. Revenue did rise sharply, to 4 billion last year from \$3.9 billion a year earlier, and amount to nearly one-fifth of Intel's total. But that's mostly thanks to Intel's flash-memory chips, which are used in cellular phones to hold data stored in memory when a device is turned off. Even including the profitable flash-memory option, Intel's new businesses—everything from Web hosting processors for phones—have reaped zilch in profits, with sales doubling nearly every year since 1998. It hasn't helped Intel's cause that Barrett has been shuffling management and reorganizing business units nearly as often as the company trots out new processors. First,

Barrett formed a new wireless unit in December, 1999, combining Intel's flash-memory business and new acquisitions, such as DSP Communications Inc., a leading supplier of chipsets and software for digital cellular communications. A year later, Barrett combined the manufacturing and development groups working on its core processors into the Architecture Group. This year, Intel's networking and communications businesses were merged into a new unit, and the architecture unit was revamped for a second time in two years. "We reset the

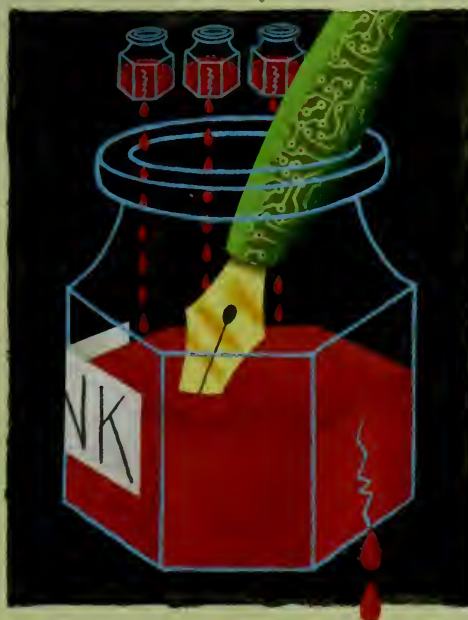
Cover Story

VENTURE CAPITAL: SHOULD INTEL STICK TO ITS DAY JOB?

When Intel Corp. announces its third-quarter earnings on Oct. 16, losses on its venture-capital investments are likely to take a big bite from its bottom line. Over the past 10 years, Intel has pocketed net gains of \$4 billion from the portfolio run by its Intel Capital unit, which has invested in the likes of BlackBerry pager maker Research In Motion, Red Hat Software, and incubator CMGI. But shortly before the September 11 terrorist attack, Intel warned that VC losses were mounting and would exceed interest income in the third quarter. The losses, the first since the chipmaker began disclosing VC results in the fall of 1999, could well drain \$200 million from the parent's pretax operating income.

Even for the tech giant, that's a serious hit. It's about as much as all the operating income Intel reported under generally accepted accounting principles for the second quarter and about one-fifth of such income calculated under the pro forma accounting the company prefers. And it's a reversal from the \$716 million profits the unit contributed during the same quarter a year ago, as well as a huge comedown from the heyday of the tech bubble in 2000, when the unit had a record \$2.1 billion windfall.

Worse may come. Intel's VC portfolio is valued in its balance sheet at \$2.7 billion, as of June 30. Just a small portion of that, \$726 million, is in quoted securities, which may be evaluated at market prices each quarter. The other \$2 billion is investments in private



companies, mostly still carried at their original cost. That private pool could turn into an ocean of red ink if sales by Intel or others set a lower reference price for the companies.

Faced with such prospects, most companies would quit VC. Already, many have: VC investments by corporations fell 90% in the first half of 2001, to \$353 million, says PricewaterhouseCoopers.

Not Intel. Leslie L. Vadasz, president of Intel Capital, says Intel is trying to keep up the pace of its venture investments. But try as he might, he's not finding opportunities to invest even half the amount he did last

year—\$1.3 billion in 300 deals. The big problem: VC firms are offering few new deals to Intel. They're too busy with problems among their portfolio companies.

STRATEGIC MOTIVE. Intel can plow on regardless because it's not in VC primarily to make money. When it began to invest a decade ago, it was looking for companies that were developing products that could help it with design and manufacturing. By the late 1990s, Vadasz was putting money into everything from PC and server manufacturers to the Internet portals—companies that could fan demand for products and services using Intel chips. "This was, is, and continues to be a strategic program," says Vadasz.

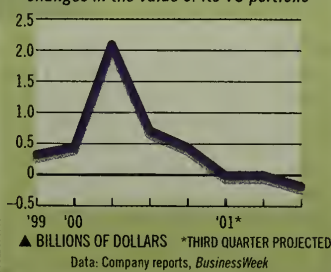
Intel's own assessments of its investments differ from conventional VCs. Consider the now-defunct eToys. Although the e-tailer collapsed, Intel cites it as a successful venture because its dynamic Web site encouraged others to improve their sites and increase demand for computing. Intel nearly tripled its \$4 million investment in eToys by selling part of its holdings before the company failed. Profits from the deal were a fraction of the \$1 billion it made from Micron Technology Inc. But to Intel's thinking, Micron was a strategic flop because it didn't advance the production of random access memory as Intel had wanted.

With the tech sector depressed, Intel may now have to curb its appetite for VC investments. Although the stock market might accept a few down quarters in VC results, its patience is unlikely to be unlimited.

By David Henry in New York

DIMINISHING RETURNS

Contribution to Intel's pretax earnings from changes in the value of its VC portfolio



whole thing," says Paul Otellini, senior vice-president for the Architecture Group.

Barrett and Grove say the moves were necessary to clean out organizational cobwebs and to reflect the realities of a more segmented marketplace. The reorganizations were designed to make Intel more fleet-footed and to avoid duplication of efforts in various units, such as the networking and communications operations each pitching similar products to customers with no coordination. Barrett explains that in the past three years he has moved four executive vice-presidents into new positions to give them experience in sales, marketing, and operations, in preparation for choosing his eventual successor. Those on the up-and-comer list: Otellini; Sean Maloney, Communications Group; and Michael Splinter, Sales & Marketing Group. Barrett also says the reorganizations were key to pushing decision-making down into the executive ranks and making Intel nimble.

BROADBAND BLUES. Too bad Intel has been anything but nimble. Customers, analysts, and former execs say many of Intel's execution problems have been the result of putting chip experts in charge of new businesses. "They keep putting chipheads in positions they know nothing about," grumbles one former employee. Nonsense, says Barrett. He insists that Intel's managers are more than capable of tackling new challenges.

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When Barrett moved into the corner office, he vowed to reinvent not only Intel's business but also its culture. He brought in consultants such as Harvard Business School professor Clayton M. Christensen, author of *The Innovator's Dilemma*, to encourage the troops to tear down the old ways. But Barrett has yet to purge Intel of a culture that is used to competing in markets where it is the only choice. Take Intel's much-hyped broadband effort. In 1998, Intel began pushing a new standard for a speedy, low-cost, digital subscriber line (DSL) chip without phone-company input, says Bob Merritt, director of emerging markets for chip researcher Semico Research Corp. That frustrated phone companies, which then refused to support Intel. In March, Intel quietly admitted it has no plans to ship the chip, and the future of that business is now up in the air. Barrett has worked on improving customer relations, but some say Intel's take-no-prisoners culture remains unchanged. "To be candid, Intel has been Intel," says Duane E. Zitzner, president of HP's computing-systems group. "I haven't observed any difference in the way they do business."

Barrett's answer is to turn up the heat on what he knows best: manufacturing. He has hurriedly ramped up a makeover of Intel's manufacturing plants, introducing the latest production technologies to help slash the costs of making chips



SEAN MALONEY

AGE 45

EXECUTIVE VICE-PRESIDENT Intel Communications Group

CHALLENGE Maloney must convince phone makers and service providers that Intel can make low-priced, high-powered communications gear

ed plants use sophisticated custom-made equipment to move parts through the manufacturing process. CIBC World Markets semiconductor analyst Quinn Bolton estimates that will push the manufacturing costs of a Pentium 4 desktop chip down to just under \$5 from about \$60 now. Intel betting it can use the same technology and factories to produce chips and chipsets for each market it is pursuing.

Barrett isn't finished doling out the dough for manufacturing advances. He's spending another \$4 billion to research promising new technologies, such as extreme ultraviolet light to draw features for increasingly complex chips that will run at 10 gigahertz and beyond, expected in 2005. Intel is getting ready to bring out new technology called hyperthreading that could be a significant boost to the power of chips by allowing one processor to perform two heavy computing tasks simultaneously—as if there were two chips in the machine instead of just one. That technology will be available for servers and workstations next year and in PCs by 2004.

Intel hopes to put miles ahead of competitors, making technical differences in its products more pronounced to boost sales. They think they really

The new, low-power XScale processor will be a **KEY TEST** for Intel in the wireless market

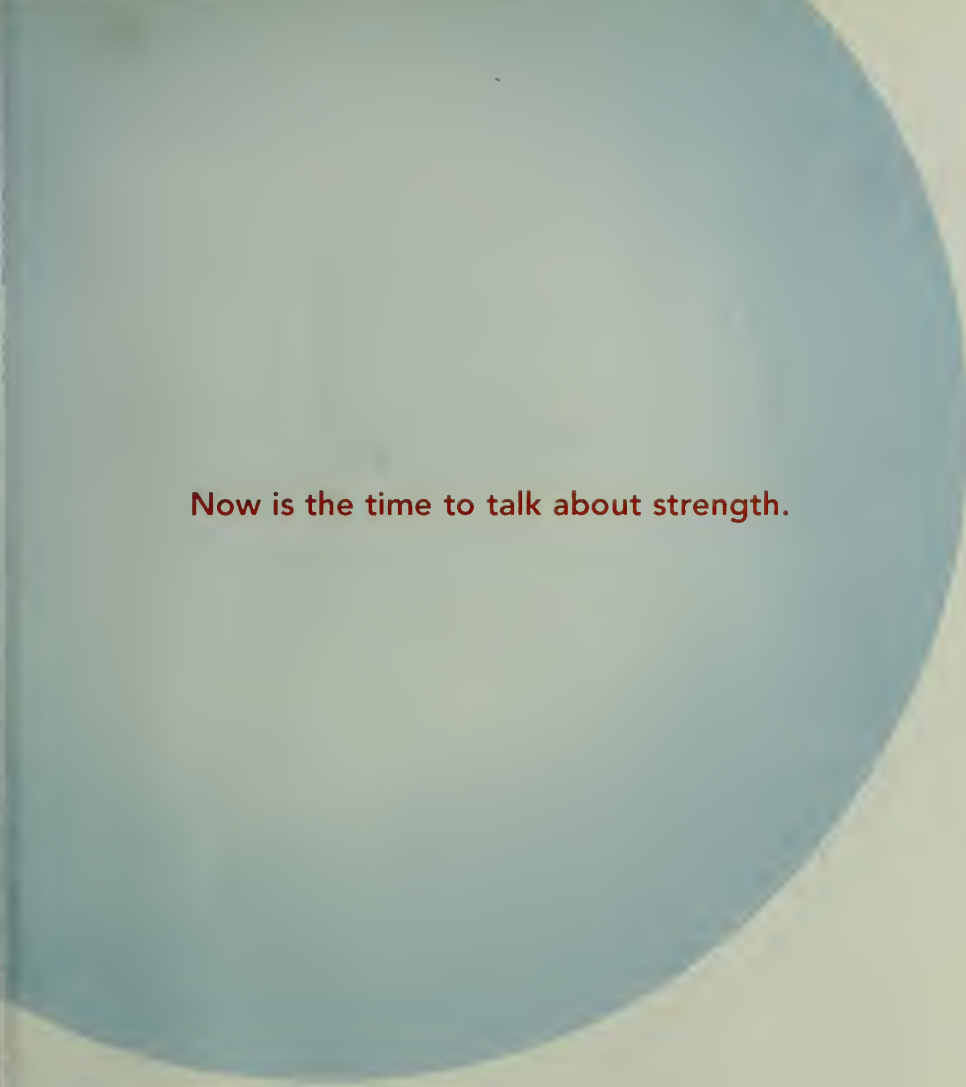
and chipsets. He is pumping \$7.5 billion, or 29% of expected annual revenues, into capital development. Intel is in the process of converting its plants to bring down costs of making chips as much as 50%. New, 12-inch wafers, about the size of a dinner plate, have 240% more room to produce chips than the current 8-inch ones, which are about the size of a salad plate. Copper interconnects boost performance by lowering heat conductivity, and shrinking the size of circuitry from .18 microns to .13 microns cuts the size of the same chip in half.

Indeed, Intel workers in sterile rooms wearing bunny suits soon could be a thing of the past, as virtually automa-

their best strategy is to out-invest and out-technology competitors," says Dell Computer President Kevin B. Rollins.

Deep pockets and manufacturing prowess, however, may be enough to help Intel dominate the communications, wireless and Web-site hosting markets. The chipmaker's best growth prospect outside of servers is in its wireless group, where hopes to make inroads with its "wireless Internet on a chip" strategy. By combining its flash memory with low-power high-performance digital and analog chips to make a single piece of silicon, Intel plans to be a one-stop shop for the makers of cellular phones and handhelds. Its edge: offering a chip that





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is two to five times more powerful than those of its rivals. Intel says Siemens and Mitsubishi have signed on. The chip-maker, however, may have a tough time persuading giants Nokia and Ericsson to abandon trusted suppliers for Intel, an unproven wireless player, says Gartner Group analyst Stanley Bruederle.

Cover Story

Rivals aren't waiting for Intel to gain a toehold. Industry leaders Texas Instruments Inc. and Motorola Inc. also are moving forward with next-generation offerings in the battle for the digital signal processor market, one of the key ingre-

dients in cell phones. And they say that Intel, the interloper, has a lot to learn in a short time. "We have over 20 years of wireless and cellular knowledge," sniffs Omid Tahernia, general manager of Motorola's Wireless & Mobile Systems Division. Tahernia says there's a huge learning curve in figuring out pricing and what customers want.

A key test of whether Intel will become a formidable player in the wireless industry outside of flash-memory chips comes early next year when it begins shipping its new, low-power XScale processor. Intel hopes to convince handheld computer makers that the chip can handle large video and audio files and can be used for always-on Internet connections.

FIGHTING WORDS FROM CRAIG BARRETT

Craig R. Barrett, CEO of Intel Corp. since March, 1998, is in the hot seat. His heralded diversification strategy has yet to deliver, and the tech downturn has pummeled his core chip business. Barrett argues that he has the right formula for returning Intel to firmer ground. The 62-year-old chief spoke with correspondent Cliff Edwards about Intel's long-term goals—and his potential legacy.

How is Intel managing through this downturn?

The only way we know of to survive one of these and come out in a reasonably whole piece is to get new products, new technology—and the design wins. You go for market share, and the rest takes care of itself.

There is concern that Intel's new businesses, such as chips for cell phones and networking gear, are not gaining traction. How are those efforts coming?

Let's be serious: A lot of people's jobs are to second-guess. We embarked on a program a couple of years ago with the following assumptions: We said the PC business was strong, would continue to be healthy, and would continue to grow—albeit at a slower rate than it had in the past. We wanted to supplement that with growth in some new areas. The areas we picked have been networking communications, wireless communications, and servers. Nothing's changed.

The PC market is still the founda-

tion of our company. It's a difficult time for everybody, but it's still providing the fuel to transform ourselves. We're not walking away from it. We said we would invest in some areas that were exciting, had good growth potential, and I'm sure as hell glad we started that a couple of years ago and are not trying to start it today. Most of those folks who are



“Folks who are second-guessing have never managed a company”

second-guessing have never managed a company. I wouldn't trade what we've done over the past two years for their second guesses.

Analysts question whether Intel tackled too many new markets at once. Did Intel take on too much?

It's one of those great Monday-morning quarterback deals. O.K., you had a product screwup, and why did you have a product screwup? Because you did too many things. Guilty as charged. We had product

screwups. Not guilty as charged—that we can't do more than one thing at a time. We can create great products in a variety of areas. I don't accept that comment, and I understand where it comes from.

Is there anything you wish you hadn't done?

Some of the acquisitions we made—I would have made them after the crash rather than before the crash. I still would have made them. I just would have paid less for them. We set out over the past year to refute those people who said we couldn't do more than one thing at a time. You're starting to really see the fruits of that labor. I would have moved faster: That's probably the only thing I'd take back.

Why faster? Some argue that you should have moved slower.

Excuse me: bull____. Nobody who wins in this industry gets there by moving slower. The one thing that has been constant in this industry for 30 years has been technological advancement. He or she who moves at the head of the technology curve reaps the benefits.

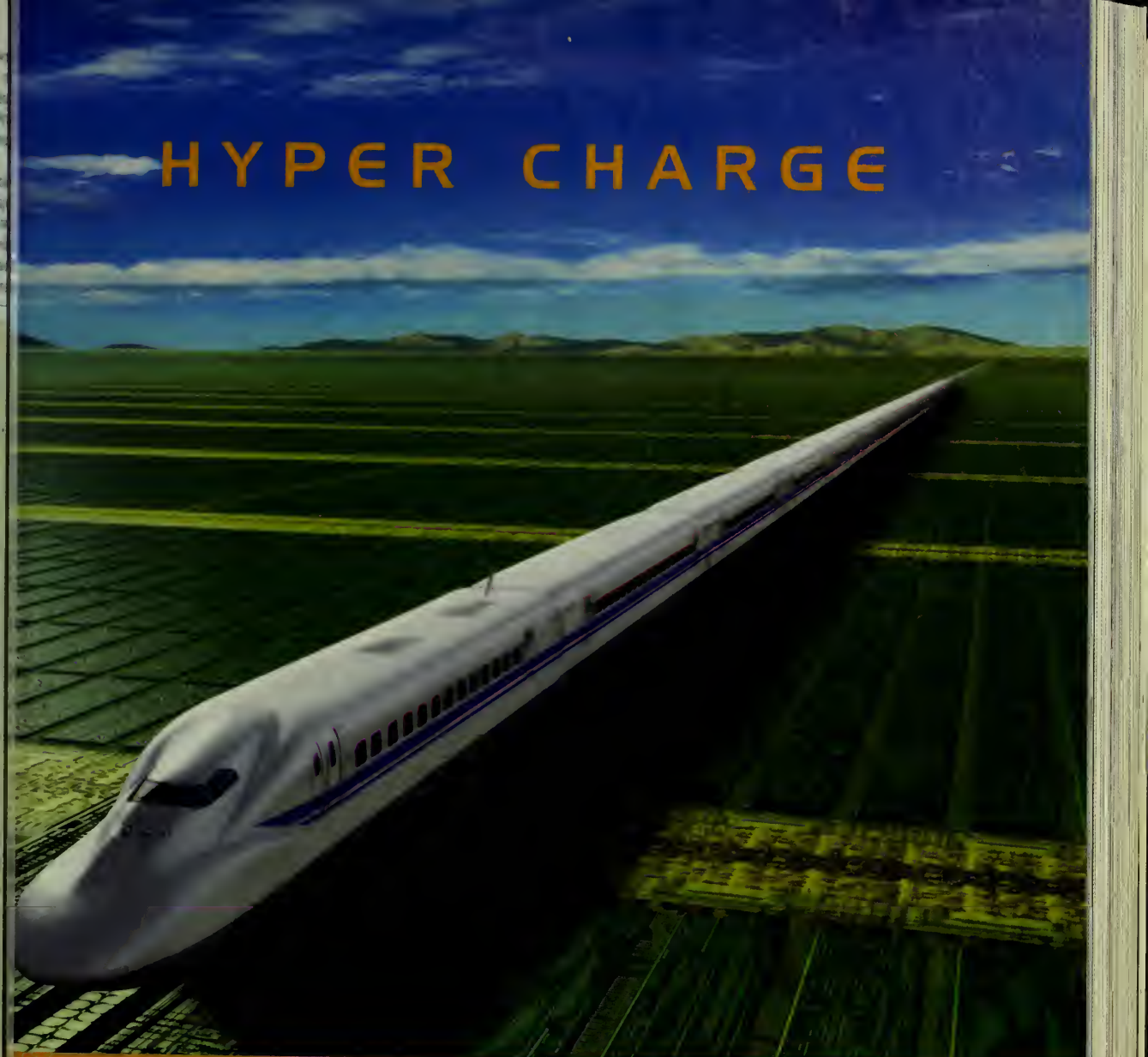
Has Intel misplaced its emphasis on powerful PC chips at a time when consumers appear more concerned with the speed of their Internet connection?

It's tough to find a 21-year-old who says: "I've got enough processing power." Frankly, it's a question I get a lot from middle-aged reporters.

You have three years until you retire. What would you like your legacy to be?

My legacy at Intel will be, I hope, to continue moving forward as a prestigious high-tech, high-growth company.

HYPER CHARGE



ed and reliability. Two things we all want, and two things Hitachi delivers, r and over. They're what give the Bullet train its legendary performance safety, even at speeds up to 177mph. They're also built into our semi-ductors such as the high-performance microprocessor, SuperH. So you process and store your valuable and irreplaceable data at the highest eds with total confidence. Whether we're transporting you or your a, you can always count on Hitachi for speed and reliability. Hitachi—ired to make life better. Visit Hitachi on the web and see how we're iring the next with our advanced technologies and innovative solutions.

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And on Sept. 26, Intel unveiled a new flash-memory chip that it claims will retrieve data four times faster than standard cell-phone memory.

In the market for Internet and networking equipment, Barrett has tried to buy his way to market leadership. In 1999, he plunked down \$2.2 billion—Intel's biggest acquisition ever—for Level One Communications, a maker of chips for broadband devices that speed data around the globe. Intel's early efforts read like a "How Not To" guide for business, says analyst Brad Day at Giga Information Group. Day says Intel bet on Level One, even though it already was late in developing fast ethernet networking products. The delays, coupled with Level One managers cashing out, gave competitors the opening to turn out products superior to Level One's, making the acquisition a questionable move. Indeed, Intel developed without Level One's engineers a router chip that's selling well, Day says.

WEB WOES. And the outlook for Intel's Web-hosting venture is even more bleak. Indeed, analysts say that even though Intel has poured \$2 billion into this business, it should exit the market. Demand from companies wanting others to run their Web operations has fallen dramatically since the dot-com meltdown. Few Web hosters are making money. And on Sept. 26, Web-hosting leader Exodus Communications filed for bankruptcy. Barrett says he is staying the course because the market will once again boom. In the past six months, Intel has forged Web-hosting and partnership deals with the BBC, Sony, and Commerce One. Still, competitors say Intel's data centers are virtually empty. "We've never run into Intel in a competitive situation," says James L. Freeze, chief strategy officer at Web-hosting company Genuity.

Such tales bode ill for Barrett's legacy. Still, he has three years to reverse Intel's slide—and 36 months can be an eternity in the ever-changing computer industry. "What people will remember him for is what he did last, how the stock did last," says Lehman Brothers analyst Dan Niles. Grove agrees that the wild cards will be the economy and how well Intel executes. In the next two months, Intel's executive team will sit down and review the strategic plan that will help determine the course of Barrett's next three years. They probably won't be able to squeeze into that cramped conference room, but wherever they go to map out future plans, Intel's legacy will loom large.

By Cliff Edwards in Santa Clara, Calif., with Ira Sager in New York and Barbara reports

Entertainment



HOGWARTS HIJINKS: The young sorcerer won't be appearing on Coke cans

MOVIES

HARRY POTTER AND THE MARKETER'S MILLSTONE

Placating J. K. Rowling meant passing up a slew of tie-in deals

Even we muggles may be unable to withstand it: children on flying broomsticks, terrible trolls, and mail-carrying owls. By Nov. 16, when Warner Bros. Inc. releases its eagerly anticipated film of *Harry Potter and the Sorcerer's Stone*, even those of us who live in a world without wizards and goblins will know a major film event is upon us. Yet for all the hype and hoopla that will precede it, *Harry Potter* arrives with relatively few of the Happy Meals, sweepstake giveaways, and wall-to-wall product placements so common to blockbuster wannabes.

Yes, a *Time* magazine cover is planned, and there will be Harry Potter watches, T-shirts, and backpacks. A barrage of TV commercials is coming. But by the time 11-year-old British actor Daniel Radcliffe brings to the big screen the bespectacled hero created by author J.K. Rowling, Harry won't have appeared on any Coke cans or cereal boxes. Warner has cut no deals with fast-food chains, cookie companies, or potato-chip makers. In all, industry insiders say the studio has signed one-third as many merchandise and sponsorship deals as oth-

er recent films, such as Universal Pictures' *How The Grinch Stole Christmas*. "With any other film, this would be huge risk," says Hollywood marketing consultant Peter Graves, a former marketing executive at Metro-Goldwyn-Mayer Inc. "But this is a film that millions of kids out there can't wait to see."

GOING IT ALONE. So why is the best seller—its U.S. publisher, Scholastic Corp., estimates more than 100 million books in the series have been sold worldwide—still seen as a big-budget wager for Warner? Made for an estimated \$109 million, the effects-laden film opens two weeks after Disney's heavily hyped film, the animated *Monsters Inc.* Unlike other films, in which

Warner shared the costs with other companies, the studio kept *Harry Potter* itself. But extra money from burger chains and other could have given a needed boost to AOL Time Warner, which revised its 2001 revenue and cash flow targets downward following September 11.

Warner isn't talking, but privately it has told sponsors it didn't want to overexpose the Potter franchise too early.



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The studio also took pains to indulge Rowling, who abhors overmarketing her books and has three more to deliver in a planned seven-book Potter series. "We can say all that stuff about not wanting to overcommercialize their franchise," says DreamWorks SKG market chief Terry Press, "but this is about giving their author happy."

Rowling, who declined comment for the story, maintained a firm hand on the film almost from the beginning, insisting chasing off Steven Spielberg as a director by insisting that only a British actor could play Harry. (Spielberg wanted Haley Joel Osment.) Rowling also insisted on limits on how major mar-

ket partner Coca-Cola Co. could spend—\$150 million it budgeted in advertising images of Harry on cans of Minute and Hi-C juice was allowed. Coke didn't use any movie image for its three commercials, one of which will stress reading as a pet cause of Rowling. Coke agreed to give more than 1.5 million books to 10,000 U.S. libraries and is giving away 100,000 \$4 books for kids to books.

FROGS. It's not as if Warner, which paid \$10 million in 1998 for movie rights for the first two books, has turned off all promotional efforts. There will be a lot of the usual tie-in for kids' movies, including Mattel play sets, video games from Electronic Arts, and trading cards from Topps's Wizards of the Coast unit. But Warner turned down potential deals with Burger King, Kraft Foods, and Baskin-Robbins. And it sent the candy makers off with a huff when it declined to license only chocolate Frogs and beans called Bertie Bott's Every-thing or Beans—Harry's

favorites. Hasbro's Cap Candy unit won the U.S. candy rights. Mars Inc. received the foreign rights. Warner kept an iron fist over all aspects of publicity as well, even limiting access by sister AOL companies. Studio execs nixed the typical Home Box Office behind-the-scenes special and refused access to Time Inc.'s *Entertainment Weekly*, which then ticked off studio execs by publishing an unauthorized cover story. Ads and products went through an unusually tough approval procedure often requiring Rowling's O.K. Gund Inc., which is making Potter plush dolls, delayed its ads a month awaiting Rowling's nod.

All this Potter-coddling gave Warner enough leverage to charge fat licensing fees, almost enough to make up the cost of the movie. But will the muted campaign help or hurt the movie's prospects? Steering clear of the usual barrage may improve its prospects with teens and adults, who might rebel against the cereal and fast-food tie-ins associated with kiddie flicks. That could mean a windfall for AOL Time Warner, says UBS Warburg analyst Christopher Dixon. He figures the movie will do \$300 million at the box office and, with foreign and DVD rights, generate \$150 million in operating profits for AOL Time Warner.

But the celluloid Harry could backfire, too. Kids, already steeped in everything Potter, may rebel against a drab movie that doesn't convey the magic of the wizard school Hogwarts or the soccer-on-broomsticks game Quidditch. If that's the case, Warner may wish it had signed on every cauldron maker that came calling a few months back.

By Ronald Grover
in Los Angeles

MAGIC AT THE BOX OFFICE?

The Hollywood hopefuls that will take on the child wizard this holiday season

MONSTERS INC.

Walt Disney/Pixar, RELEASE NOV. 2
Pixar's hot streak will continue with a tale of imaginary monsters in the closet, but Potter could scare its box-office potential. BUDGET: \$95 MILLION

SPY GAME

Universal Pictures, NOV. 21
Lackluster drawing power of Brad Pitt and Robert Redford may push the studio's recent luck in this espionage story. \$85 MILLION

OCEAN'S ELEVEN

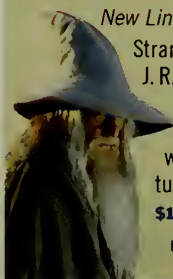
Warner Brothers, DEC. 7
George Clooney, Pitt, Julia Roberts & Co. score big in Vegas with this remake of 1960 robbery flick. \$90 MILLION

ALI

Columbia Pictures, DEC. 25
Will Smith is a dead ring for the great boxer. \$105 MILLION

LORD OF THE RINGS

New Line Cinema, DEC. 19
Strange and dark, J.R.R. Tolkien's tale of battling hobbits will score with guys but may turn off their dates. \$110 MILLION



Data: upcomingmovies.com,
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DASHED HOPES FOR DOT-COMS

September 11 could turn expected profits to losses—particularly for travel outfits

On Sept. 10, Expedia Inc. Chief Executive Richard N. Barton thought he had a nice earnings surprise in store for Wall Street. Only two days after posting its first profit, the travel agency was piling up revenues at a clip to reach \$90 million for the quarter ending in September—\$10 million above target. Then it hit the World Trade Center, the Pentagon, and Expedia's revenues came up \$10 million short over the next few weeks. That drop will reduce its profits from \$1 million to \$6.1 million, says Prudential Securities Inc. analyst Mark Lowen. Now Barton is worried about deepening losses. "I'm waiting for people to be ready to get back to normal," he says.

Barton and other leaders of the consumer Internet industry may be waiting a long time. The September 11 disasters at the heart of some of the success stories of Net—travel and finance companies, in particular—that had defied the odds and actually become profitable, most of them on a pro forma basis. While the A-team players have bright prospects long term, a tight economic downturn could slow profit growth for such players as Expedia, travel agent Travelocity.com, name-your-price site Priceline.com, real estate site Homestore.com. A long recession could make a



Slipping Backward

The World Trade Center and Pentagon disasters caught Internet companies just as they were starting to deliver pro forma profits. Here are some dot-coms that could get hit hard in the fourth quarter:

COMPANY	PRE-WTC 4TH QUARTER PROFIT ESTIMATE*	NEW ESTIMATE*	ANALYSIS
YAHOO	\$17.2	\$11.5	Analysts see holiday ad sales off 10% to 20%
EXPEDIA	11.1	1.5	Business fell 55% after disasters
TRAVELOCITY.COM	5.9	0	Relies mainly on airline ticket commissions, so lower volumes hit home
HOMESTORE.COM	21.8	14.1	Could get worse if real estate tanks
PRICELINE.COM	8.8	0	Its target customers, consumers, are especially skittish about travel

* Numbers, in millions, are pro forma profits, excluding accounting adjustments. Data: First Call/Thomson Financial, Goldman Sachs, Merrill Lynch, Prudential Securities, Yahoo Finance

number of the profitable companies profitless again.

For dot-coms that were barely hanging on, this crisis could be the knockout punch. Dozens of consumer Web sites were already low on cash and losing money fast. Struggling jewelry retailer Ashford.com Inc., with just \$6 million in cash at the end of the second quarter, has agreed to be purchased by Global Sports Inc. Buy.com Inc., the discount e-tailer, has only \$14.5 million in cash after burning through \$51.8 million during the first half of the year. Closings of consumer sites have tapered off in recent months since the weakest ones have already been flushed out. But more failures are likely now.

The setback comes at a particularly inopportune time for the profitable dot-coms. After edging into the black in recent quarters, some of these companies were poised to turn in sizable income—the long-awaited payoff for years of investing to gain traction. They finally had enough revenues to cover their fixed costs and marketing expenses. Additional business required little extra staff or computer gear. Now, profits are getting squeezed because the same logic works the other way. Even small interruptions in sales take an outside toll. Witness Homestore's Oct. 3 announcement that a \$9 million to \$13 million revenue shortfall could produce a loss of up to \$6.5 million in the third quarter. Goldman Sachs had earlier projected a \$14.6 million profit.

"GAMBLING." For investors, the profit crunch means these companies' stocks may be significantly overpriced. The prospect of long-awaited profits sparked an early-year rally that had a *BusinessWeek*-compiled list of 37 profitable Web companies trading in late August at 97 times this year's expected profits and 41 times next year's estimates, according to First Call/Thomson Financial. Investors have driven down their stock prices recently, and analysts have cut estimates. But the group of Web companies is still trading at 31 times next year's earnings—55% higher than the Standard & Poor's 500-stock index. Shares of online trader E*Trade began the year at \$7, peaked at \$15, and now trade at \$6—giving it a multiple of 149. Experts warn investors to be wary. "To bet on things that are not likely to happen is gambling," says Penn State finance professor Gary Gray.

Some companies are reacting

quickly. Priceline and Expedia responded first by cutting advertising almost entirely. Both companies have subtly rearranged their sites to push close-to-home hotel and rental car packages they hope will be less affected by consumers' fear of flying. Priceline also has cut back on the number of outsourced customer-service reps it hires from contractors.

They're right to react, since the most vulnerable piece of the dot-com universe is online travel. Air travel has been all but moribund since September 11. Even with most airlines canceling up to 20% of their flights, planes are half-empty. As a result, Travelocity and Priceline are likely to come close to losses in the fourth quarter. Prudential's Rowen says Expedia will make about \$1.5 million in the fourth quarter, down from the \$11.1 million he forecast before the attacks.

RESERVES. Online mortgage and real estate sites aren't hurting yet, but that could change if people stop buying houses and borrowing. The shaky real estate market holds the key to the fortunes of Web players such as Homestore.com, LendingTree.com, and E*Trade, which sell real estate-related ads or mortgages. In the short term, real estate lending is improving from a near-crisis right after September 11. LendingTree says its applications were 42% below normal the week of the crashes, but 40% above normal by the week of Sept. 24.

Earnings estimates are coming down sharply for companies that depend on Web advertising. Yahoo Inc. tops the endangered list among the profitable ad-dependent dot-coms. The reason: It's almost alone among profitable Web companies in relying on ads for more than 80% of revenues. Just to break even on estimated revenues of \$608 million for 2002, Yahoo would need to make cost cuts. U.S. Bancorp Piper Jaffray analyst Safa Rashtchy says Yahoo's sales could drop 10% to 20% in this year's fourth quarter.

The good news is that none of the profitable dot-coms are facing cash shortages. They're cash-flow positive now, and even if the downturn is deep and long, they have enough reserves to tide them over if they become unprofitable for a few quarters. Homestore.com has \$175 million in cash. Priceline.com has \$165 million.

Long-term trends in online travel and e-finance are still favorable, and even online advertising will find its niche in the media constellation. But the striking thing about the profitable Web companies was how quickly the market last spring bid up their stocks. Next time, investors will likely be more skeptical.

By Timothy J. Mullaney
in New York

COMMENTARY

By Gary Weiss

SHUT DOWN THE LAUNDERERS? NO WAY

In the aftermath of September 11, money laundering has taken on a new and devastating dimension. In an effort to attack the clandestine funding used to bankroll terror networks, the Bush Administration introduced on Sept. 27 a list of proposals aimed at making it harder for overseas terrorists to send money into this country. In testimony before the Senate Banking Committee on Sept. 26, Assistant Attorney General Michael Chertoff declared that money laundering is a "threat to our national security."



WRONG APPROACH Terrorists don't need banks, and have dozens of ways to ship cash

Such arguments have cut the floor from under longtime opponents of stronger money laundering laws, including Senator Phil Gramm (R-Texas) and the American Bankers Assn. "We generally will be extremely supportive," says Edward L. Yingling, executive director of ABA government relations.

The Administration's proposals would toughen and broaden the laws restricting money transfers, and make it easier for the feds to gather evidence. They're good ideas. But they have little chance of turning off the financial spigot that finances terrorist operations in the U.S. "Money laundering is never going to be eliminated. The only way to get rid of it is to eliminate profit-oriented crime,"

says Charles A. Intrigo, publisher of *Money Laundering Alert*, a Miami-based newsletter.

Policing money laundering is a law-enforcement nightmare. Many schemes—including the *hawala* money-transfer networks in South Asia and the Mideast—use unrelated accounts in different countries, making them hard to shut down. U.S. crooks, similarly, often wire the proceeds from drug or stock-fraud enterprises to foreign bank or brokerage accounts. A stateside contact then pays the U.S. criminal after deducting a fee of 6% or

so—a cost that's likely to soar because of the crackdown.

NEW SPIN. In contrast to U.S. wiseguys, Middle East terrorists have a more straightforward money-moving task. All they need in the States is a bank account to disburse the funds and one of innumerable ways of getting cash into the country. Getting an account in the U.S. is easy with false I.D. But terrorists can avoid banks and deal entirely in cash. To combat large-scale cash transports, one of the Administration's proposals would make it a crime to transport more than \$10,000 across state lines if intended for an unlawful purpose. But terrorists can get around such a law by simply divvying up their cash shipments.

That's the fundamental problem with all anti-laundering laws. As soon as they are published, criminals figure out ways to circumvent them. So money-washers have proven almost impossible to eradicate. "I call it the second-oldest profession," says Intrigo. He notes that money laundering is even mentioned in the New Testament, in the tale of Ananias and Sapphira. After hiding a quantity of money that was due to be given to Peter, the two sinners, confronted with their shame, "fell down and died." Not a very likely outcome in the fight against this latest breed of financial criminal. But it's a lovely thought, isn't it?

Senior Writer Weiss has written extensively about organized crime.

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FREEZE ASSETS NOW, ASK QUESTIONS LATER

Are banks being too zealous in the race to trace terrorist funds?

When Mohammad N. Ahmad, a manager in the global telecom division of Lockheed Martin Corp., logged on to his Citibank account on Sept. 25, he was greeted with a blank where his balance should be. When he called his branch in Gaithersburg, Md., he was asked to come by. The branch manager referred him to the bank's New York compliance office, which told him they had to freeze his assets. His name, as common in Arabic as John Smith in English, triggered the freeze.

Pakistan-born Ahmad, an American citizen since 1995 and Citibank customer for over a decade, is one of hundreds of Arab and East Asian Americans snared in the net cast by the Administration to locate any and all possible sources of

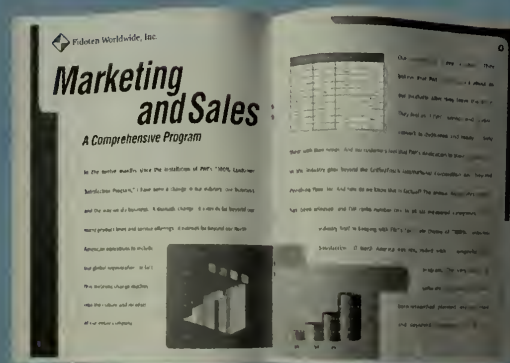
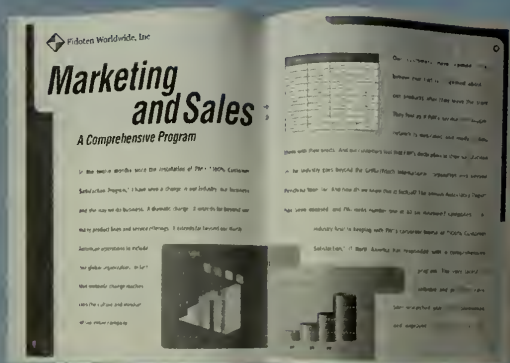
funding for the terrorist acts of September 11. Just two days before his accounts were frozen, the Treasury's Office of Foreign Assets Control issued a list of 27 suspect organizations and individuals to U.S. financial institutions. Mustafa Muhammad Ahmad was on the list, but Mohammad N. Ahmad wasn't. Government instructions, bankers say, were to freeze assets now and ask questions later. The practice is sure to raise more cases of mistaken identity: A second, larger list of individuals and groups suspected of links to terrorism is in the works, according to Treasury officials.

In a sudden reversal, U.S. financial institutions, long loath to snoop for the government, are falling over themselves to comply. They spent millions lobby-



ing against money-laundering legislation and so-called know-your-customer bills proposed in 1999, calling them intrusive and burdensome. Today, they're scrambling to search and seize accounts, partly to dodge stiff administrative fines but also to ensure that their reputations aren't sullied. It's understandable, say

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Telecom exec Ahmad says his follow-up inquiries have been met with “absolute, total silence” from Citibank

palled by the sweep that's going on,” says Bert Ely, head of Ely & Co., who testifies regularly to Congress on privacy issues. “The FBI is asking banks to run this huge dragnet to compensate for the fact that they got caught with their pants down.”

Even though his account was restored three days later, the impact on customers like Ahmad is unsettling. “This account is where my paycheck goes and where I pay my bills from,” he says. Not only could he not access his money, but Citibank also told him any outstanding checks could bounce, potentially tainting his credit. Since then, inquiries about the outstanding checks and his account in general have been met with “absolute, total silence,” says Ahmad. A spokeswoman for the bank's parent, Citigroup, said only that the bank is “cooperating fully” with the government investigation. **“OVERKILL.”** The hunt raises new questions about how much information banks should have about their customers and to what extent they should cooperate in government investigations. “There is an ongoing battle between privacy and money laundering. Everyone is searching for where the line is,” says Vernon W. Hill II,

CEO of Commerce Bancorp Inc.

Wherever that line is finally drawn, new rules for banks and tougher scrutiny for banking customers are certainly on the way. Already, an anti-terrorism bill before Congress expands government powers to seize suspected terrorist assets. Banks are stepping up I.D. requirements and background checks for products such as debit cards—terrorists used one to rent a car.

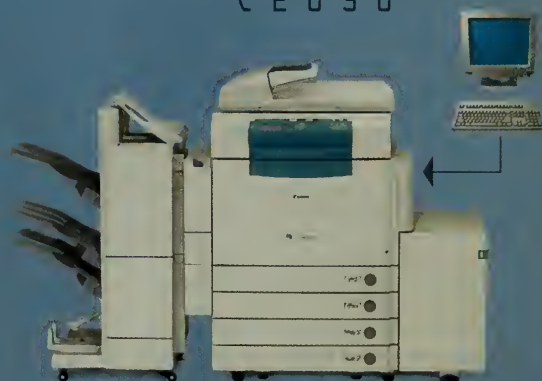
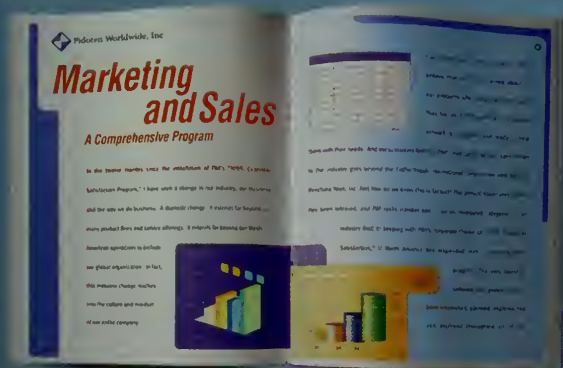
The rules, and the shape of bank policies, are still in flux. But already, measures that seemed intrusive before September 11 now look like common sense, says Peter P. Swire, a law professor at George Washington University and a Clinton Administration privacy counselor. He adds: “We still have to figure out which are overkill.”

Right now, the banking industry is erring on the side of excess. “We do see a shift in the banking industry's attitude” to know-your-customer policies, says a senior Treasury official. Some banks are overreacting, he admits, but “it gets worked out very promptly.” That's cold comfort if your name is Mohammad Ahmad.

By Heather Timmons in New York, with Mike McNamee in Washington

L. Sorkin, a partner with New York firm Squadron Ellenoff Plesent &infeld and a former Securities & Exchange Commission administrator. That bank wants to be known as the repository for the Taliban?” he asks. The banks' reactions, though, are raising the ire of civil libertarians. “I'm ap-

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COMMENTARY

By Mark Hyman

THE TROUBLE WITH BARRY

Hardly a day goes by that Barry Bonds isn't the lead sports story on the evening news. But as the San Francisco slugger glides toward baseball's single-season home-run record, the question that remains unanswered is: Can 71 homers buy Barry love?

For any other ballplayer of Bonds's stature, all that media attention would almost guarantee endorsement riches. Chicago Cubs hitter Sammy Sosa lost his famous home-

"Why would a company align itself with a person who's not likable?" asks image consultant Kathleen Hesselert, president of Sports Media Challenge. "Barry Bonds hasn't made himself likable yet."

It isn't as if Bonds, 37, does no endorsements. Armour is paying him about \$200,000 over two years to appear on hot dog packages, and he's been a reliable performer for the wiener company. "I questioned his commitment to do this kind of

nant race this year. In the clubhouse, he gets three lockers—his teammates each get one—and rates his own TV and a \$3,000 black-leather recliner.

ALL SMILES. Bonds, whose baseball salary this year is \$10.3 million, probably wouldn't be jumping at every endorsement deal even if more were being offered. "Clearly, Barry doesn't need the money...[or] the fame. He has accomplished more on the baseball field than anybody in the history of the game," says Dennis Gilbert, his former agent. There's little doubt, though, that Bonds is trying to put on a happier face.

As the home runs have mounted, Bonds has been a model of gracious manners, reminding some observers of his godfather, Giants hero Willie Mays. At news conferences, Bonds flashes an infectious smile and handles questions like the team player critics claim he has never been. And after the terrorist attacks, he pledged \$10,000 to the United Way for every new home run he hit this year.

MR. PRICKLY agents] are working...to make him more endearing," says Leonard. But will the makeover be enough? Leonard points out that September 11

and the fact that the home-run record was broken so recently could also limit the potential deals available to Bonds. Also, the runaway inflation in home runs over the past 25 years tends to devalue the achievements of power hitters like Bonds.

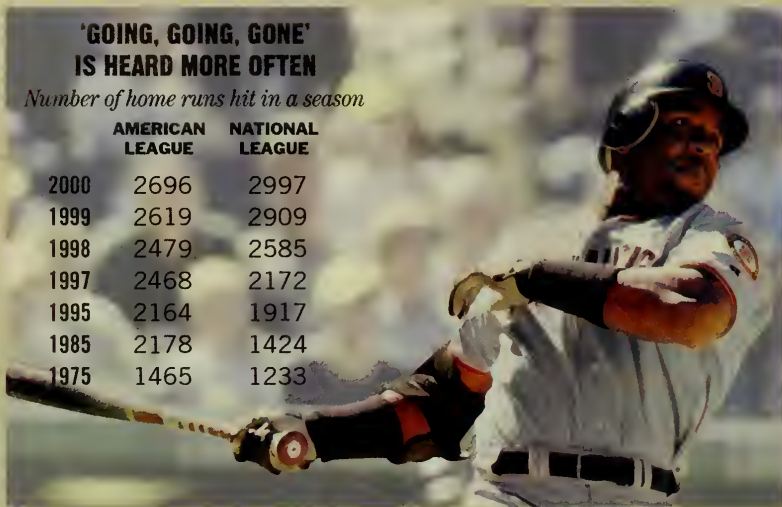
Advertisers already were watching their budgets before the terror attacks. Those still spending have a lineup of marketable baseball stars—retirement-bound Tony Gwynn and Cal Ripken Jr. and Japanese phenom Ichiro Suzuki—to choose from. "Where is the shelf space for Barry Bonds?" asks David Carter of Sports Business Group, a sports-marketing firm in Redondo Beach, Calif. In the end, endorsements may be the one home run Bonds never hits.

Hyman is contributing editor for Sports Business.

'GOING, GOING, GONE' IS HEARD MORE OFTEN

Number of home runs hit in a season

	AMERICAN LEAGUE	NATIONAL LEAGUE
2000	2696	2997
1999	2619	2909
1998	2479	2585
1997	2468	2172
1995	2164	1917
1985	2178	1424
1975	1465	1233



run duel with Mark McGwire in 1998 and still raked in \$5 million to \$10 million in deals with Pepsi, MasterCard, Fila, and other brands. Yet in the world of corporate pitchmen, Bonds so far gets treated more like a pesky singles hitter than one of the top six home-run sluggers of all-time.

DINNER FOR ONE. "A lot of it has to do with Barry. For most of his career, he has been seen as truculent and standoffish, even with teammates," says Mark Leonard, president of Integrated Marketing Solutions in Chicago and the marketing agent for Sosa. Bonds has been a no-show for the Giants team photo for the past two years and often skips other team activities. He has a flex coach who leads him through pregame stretching—alone. And after games, while other players swarm over the dinner buffet, his personal nutritionist whips up a meal for one.

thing," says Steven Silk, president of the ConAgra Foods unit that runs Armour. "[But]...he has diligently done what we've asked him to do." Bonds has also shilled for companies such as Pacific Bell.

So far, though, the big deals—pitching cars, soft drinks, and fast food—have eluded baseball's biggest bopper. His marketing agent, Reed Bergman, predicts that will change, though he declines to name a major deal in the offing. "Corporations realize that his exposure is going through the roof. They want to partner with him," says Bergman, head of Impact Sports Marketing in Atlanta.

Many of those companies might have flocked to Bonds years ago if Mr. Prickly wasn't such a PR challenge throughout his 16-year career. Many of his mates see him as self-absorbed, even though he almost single-handedly kept the Giants in the pen-



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The Top 25 Schools

Our rankings of these increasingly popular programs may surprise you

When Joseph O'Boyle enrolled in an Executive MBA program—a rigorous two-year degree aimed at high-potential senior managers—his motives were simple. “I’ve got a quant background, and I wanted to round out my management skills,” says the 38-year-old audit manager at the Chicago office of financial-services company ABN Amro Inc. But he soon realized he was learning a lot more than he expected. The program at Northwestern University’s Kellogg Graduate School of Management threw together an unlikely mix of students—from a scrap-metal dealer to a beverage executive—in one study group, and the collective expertise spilled over the classroom. Together, they mapped out a plan to overtake a fellow student’s lackluster family business—and today, the company is healthier than ever. “We all had different backgrounds, we all had something different to add,” says O’Boyle, whose company paid his way. “It’s really what makes the program work.” That tight teamwork approach has become a hallmark of Kellogg, which earns the No. 1 spot in *BusinessWeek*’s first ranking of EMBA programs in a decade. The B-school’s reputation among directors of other EMBA programs is second only to its popularity with students. Every Kellogg student answered the *BusinessWeek* survey—about 65% of the recent graduating class—said they would choose Kellogg again. Grads also praised the caliber of instructors and

their ability to draw on students’ experiences as managers.

The importance of excellent teachers and relevant coursework were dominant themes among the 3,041 students at 82 schools—a 60% response rate—who responded to the 2001 survey. *BusinessWeek* set out to gauge the satisfaction of EMBA students, similar to the customer-focused methodology used in the biennial ranking of full-time MBA programs (Best B-schools, Oct. 2, 2000). For this ranking, the graduate poll accounted for 50% of the overall score of a program, while a poll of EMBA directors at those schools made up the balance of the score (page 106).

FAMILY-FRIENDLY. In the new rankings, the No. 2 place went to Kellogg’s nearby rival, University of Chicago Graduate School of Business. With few exceptions, Chicago grads graded their teachers and support staff as excellent, citing engaging professors and in-depth courses as Chicago’s strength. Respondents also gave Chicago high marks for treating them as the adult, mid-career, family-minded students they are—a sore point at some other

programs. “From Day One, the school included my family in everything,” says one 2001 grad who, like many EMBA students, traveled to another city for a class every other weekend and studied extra hours.

Rounding out the top five EMBA programs for 2001: the University of Pennsylvania’s Wharton School, which scored No. 3 and earned top honors in the directors’ poll; Duke University’s Fuqua School of Business, which came in fourth, with praise from grads for the relevant curriculum; and the University of North Carolina’s Kenan-Flagler Business School, No. 5, whose program includes popular three-day seminars on leadership and ethics. With a

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Grads gripe: More respect, please

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1 Chicago

3 Wharton

4 Duke

5 UNC

tuition of \$54,000, UNC offers the best value of the five.

There are a few surprises, too. A relative newcomer, the seven-year-old International EMBA program at Georgetown University's McDonough School of Business, posted ninth, garnering kudos for its strong international emphasis and good faculty. Also unexpected was Columbia University Business School's low grade. Long considered a giant in the EMBA world, the program received the lowest score for student satisfaction among the Top 25. Grads complained about an oversize program and disappointing instructors. They rated Columbia teachers as only "average"—with the exception of a few top-notch professors—and criticized the school for failing to

foster a sense of community. Safwan Masri, vice-dean at Columbia, says the school has recently embarked on an "ambitious teacher development program" to address instruction quality.

Ever since Dartmouth College offered up the first-ever MBA course in railroad accounting a century ago, B-schools have catered to younger, full-time students just a few years into their careers. Executive-level MBAs didn't come on the scene in full force until the late 1960s, when Wall Street firms began to seek a steady stream of senior execs uptown to Columbia to hone their managing skills. Today, EMBA programs are a staple of corporate life, offering executives advanced degrees without having to enroll in a full-time master's program. And they're big business for the B-schools, bringing in more than \$150 million each year at the Top 25 alone. Besides providing a crucial revenue stream to the schools, EMBA students offer ivory-tower

Special Report

EXECUTIVE EDUCATION

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How the Report Card Gets Graded

Executive MBA programs charge big bucks for their rigorous programs. But how do they stack up? The letter grades are based on graduate surveys. The top 20% in each category get As. The next 25% get Bs. The next 35% are awarded Cs. And the bottom 20% get Ds. See page 106 for more information on how we crunched the numbers.

SCHOOL	GRAD POLL	DIRECTOR POLL	TOTAL* TUITION	ENROLLMENT* WOMEN	MINORITIES	GRADS' YEARS MGMT. EXP.	SCHOOL GRADED TEACHING CURRICULUM
1 NORTHWESTERN (Kellogg) Evanston, Ill.	1	2	\$91,500	22%	17%	11.4	A A
2 CHICAGO Chicago	3	3	82,000	17	4	10.9	A A
3 PENNSYLVANIA (Wharton) Philadelphia	7	1	106,600	19	NA	7.8	A B
4 DUKE (Fuqua) Durham, N.C.	10	4†	66,000	12	12	9.0	B B
5 UNC (Kenan-Flagler) Chapel Hill, N.C.	2	7	54,000	16	7	6.8	A A
6 USC (Marshall) Los Angeles	6	8†	64,120	21	7	12.3	A C
7 NYU (Stern) New York	27	5	96,400	25	9	6.6	C B
8 EMORY (Goizueta) Atlanta	11	8†	63,888	26	9	8.8	B B
9 GEORGETOWN (McDonough) Washington, D.C.	5	24	66,600	18	20	10.3	A A
10 UCLA (Anderson) Los Angeles	22	6	60,370	16	10	9.0	A C
11 PEPPERDINE (Graziadio) Culver City, Calif.	4	22†	62,800	18	17	8.3	A A
12 TEXAS-AUSTIN (McCombs)	12	10	53,000	15	3	6.5	B C
13 IMD Lausanne, Switzerland	8	21†	66,500	11	NA	11.3	B A
14 PURDUE (Krannert) W. Lafayette, Ind.	9	15	45,000	18	12	7.1	A B
15 W.ONTARIO (Ivey) Mississauga, Ont.	14	12	42,000	20	NA	11.2	B B
16 WASHINGTON U. (Olin) St. Louis	17	9	65,500	22	0	10.1	B B
17 VANDERBILT (Owen) Nashville	15	20†	63,500	24	4	8.6	C B
18 COLUMBIA New York	55	4†	97,250	26	15	6.8	D C
19 SMU (Cox) Dallas	26	11	55,825	16	9	12.3	C B
20 GEORGIA STATE (Robinson) Atlanta	16	18	41,500	32	15	11.2	B A
21 THUNDERBIRD Glendale, Ariz.	20	20†	51,000	29	12	10.3	B B
22 BOSTON U. Boston	23	27†	59,500	22	5	10.3	B B
23 LONDON BUSINESS SCHOOL London	33	14	54,000	18	NA	6.7	C B
24 QUEENS U. Kingston, Ont.	29	23†	44,000	26	NA	9.3	C B
25 MINNESOTA (Carlson) Minneapolis	35	16	54,000	35	15	10.1	C D

*Provided by Business Schools, tuition figures for out-of-state students, where applicable; enrollment figures for most recent class

** Based on a compilation of EMBA Graduate Responses

† Tie between schools

academics a valuable window on real-life business issues. Students provide "a constant source of reality checks," says University of North Carolina business law and ethics professor Bert J. Adler.

Just how important are EMBA programs to corporations? Definitely, they're very important. In this year's survey of 15, 52% said their companies paid full tuition, and nearly all corporations gave their managers time off for their studies. But the number of students paying their own freight is rising, adding pressure on schools to provide career counseling (page 1). Another concern: the weakening economy, which could hurt both EMBA and nondegree executive education programs as corporations tighten their belts.

Over the past few years, B-schools have also ventured far from their home campuses, creating a wide collection of

student-centered of EMBA programs; students praise format, knowledgeable faculty, and support staff.

Recently expanded from 18 months to 20; Chicago campus integrated courses in Singapore and Barcelona.

Executive program; students laud program's curriculum and support staff; program opens in 2002.

Team-oriented program that focuses on real-world practices; also offers distance learning programs.

Good balance of theory and practice as well as commitment of faculty; includes overseas EMBA partner programs.

Class meetings emphasize themes instead of functional areas; grads praise professors' attention to detail.

Utilizes New York business leaders; new emphasis placed on finance and management in 2002.

Month program makes for rigorous study, fewer electives; independent study allows for one-on-one work with senior faculty.

Global business focus and overseas residential modules give grads hands-on experience outside U.S.

Seven-month international consulting project needs more focus, say students; they praise enthusiastic, leading-edge faculty.

Focus on leadership and ethics in business; all grads required to do work to stay on top of the issues.

Each student mentors program entrants; partner program with a B-school City.

Mandatory "discovery expeditions" to business centers around the world; focus on international focus.

Two-week residential periods; 59% of students live more than 500 miles from campus; praise knowledgeable, experienced profs.

General management, case-study method skills; school no longer offers evening program.

Concentrations in health services management and manufacturing and engineering; new state-of-the-art building and popular London session.

Health-care management concentration; grads laud new director Martin formerly Purdue's director.

Classes are too large, and expansion of global program left weekend underfunded; outside execs are frequent guest speakers.

Modular half-semester allows more electives; spouses accompany students on international field trip.

Marketing targets women; grads note support staff inconsistencies; top users include Georgia-Pacific and BellSouth.

International business; required courses include Cross-Cultural Communication, a foreign language, plus class time abroad.

Interwoven across functional areas; ties to Boston business community; access to the classroom for case discussions.

Students are from outside Britain; global focus reinforced by two required courses to places like India and South Africa.

Videoconferencing technology allows students to tune in at 23 sites; focus on more non-Canadian business perspectives.

Top students in top 25; hiring an executive coach to deal with EMBA issues; grads want more flexible curriculum.

Data: *BusinessWeek*, Cambria Consulting

Research by Jennifer Merritt, Frederick Jespersen, Brian Hinds, Mica Schneider

global programs. *BusinessWeek*'s 2001 EMBA ranking are based only on a school's primary campus program, but students in the global programs at Duke, Chicago, and the University of Toronto were also surveyed. Grads of Duke's five-year-old Global Executive program, held in Durham, N.C., and in cities like Frankfurt, Prague, or Santiago, Chile, over 19 months—praised the program's teaching and structure. But grads of some of these programs found the quality disappointing. For example, graduates of Chicago's Barcelona EMBA faulted professors—who fly in from Chicago—for not addressing enough non-U.S. business cases and ideas.

CLASSMATES COUNT.

Often more effective, report students, are international alliances between schools. NYU has a joint EMBA with HEC Paris and London School of Economics, while Columbia linked up just four months ago with London Business School. Students are already raving about the program and exposure to LBS professors. Columbia will also begin a joint EMBA with University of California at Berkeley's Haas School of Business next year.

Above all, the quality of teaching and classes, along with instructors' ability to incorporate these seasoned managers' experiences into classwork, are key to overall student satisfaction. Students overwhelmingly say they want deep coverage of "a broad scope of course material that's ideal for leadership and management positions" along with a "commitment to student needs" and "excellent professors." Having high-quality classmates to learn from is also crucial, says Gregory Fleischmann, a Columbia grad.

Probably the hardest subject to teach, but one that requires the most professor-student interaction, is leadership. It's something companies always want more of from their managers, particularly in an economic downturn or a crisis. No crisis could be bigger than the one left by the September 11 terrorist attacks on the World Trade Center and Pentagon, say many professors and administrators. For one, it showed that leadership is about more than just making decisions, says Andre van Niekerk, director of Pepperdine University's EMBA program. It also entails displaying courage, managing employee expectations, and paying attention to ethics.

Leadership is one of Pepperdine's specialties and one that wins high marks from grads. Now the school is sure to cite a new example of leadership and tough decision-making. A 1995 Pepperdine EMBA grad, Thomas E. Burnett Jr., 38, was a passenger on United Flight 93, which crashed into a Pennsylvania field after Burnett and others tried to overwhelm its hijackers. "Tom assumed a mantle of class leader, so there was really no surprise when we heard what he had done," says former classmate James Heath.

Until last month, most EMBA programs taught crisis management through the classic, 20-year-old Harvard Business School case study of how Johnson & Johnson's responded to the cyanide contamination of their popular pain reliever, Tylenol. But now, say many EMBA directors, classes will need to focus on a world changed by the events of Sep-

Who Is the Typical EMBA Student?

AGE 37

GENDER male (78%)

FAMILY married with one or more children

WORK HISTORY at least seven years at current employer

MANAGEMENT EXPERIENCE about nine years

SALARY \$76,000-\$100,000 annually at the start of program

RESIDENCE within 100 miles of program

Data: *BusinessWeek*, Cambria Consulting

Best of the Bunch

EMBA Grads Ranked These Schools Tops by Subject Area



STRATEGY	ETHICS	MARKETING	FINANCE	GLOBAL BUSINESS
1 Georgetown	1 Pepperdine	1 Duke	1 Chicago	1 Georgetown
2 Cranfield	2 Notre Dame	2 Georgetown	2 Vanderbilt	2 Thunderbird
3 Vanderbilt	3 Northwestern	3 Northwestern	3 U. of Rochester	3 UNC-Chapel Hill
4 Pepperdine	4 UNC-Chapel Hill	4 Emory	4 UNC-Chapel Hill	4 Duke
5 IMD	5 Georgetown	5 Georgia State	5 Pennsylvania	5 Emory

Schools not ranked in the top 25 are eligible for subject rank.

tember 11. Says Dan Nagy, associate dean for executive programs at Duke, who teaches a case study on Boeing Co.: "Now I need to ask my class, 'If you're the CEO or a vice-president at Boeing, hit by this tragedy, what are your short- and long-term goals. How do you help your employees?'"

While class content is critical, student diversity also figures into the EMBA experience. Schools like the Uni-

versity of Minnesota's Carlson School of Management and Georgia State University's Robinson School of Business benefit from a considerable number of women and minorities in class. "We've made a direct appeal to corporate HR departments at our largest sponsoring companies," says Sidney E. Harris, EMBA director at Georgia State. The B-school also markets directly to successful female managers. Both efforts account for a current class comprised of 32% women.

Recruiting women isn't so simple, counter many administrators. For one, there are fewer female managers therefore fewer female EMBA candidates. And schools say women resist the rigorous schedule that interferes with family responsibilities.

What can make it easier for women—and all students—are the special touches from a program's support staff. Juggling 60-hour workweeks, senior management responsibilities, and family life, these thirty- and fortysomethings also find it difficult to manage details such as buying books, registering for classes, or finding lodging. So many schools take charge of the logistics, even transportation to and from the airport. Which schools got an A in TLC? Topping the list after Kellogg, according to grads: UCLA's Anderson School, Wharton, UNC, and the University of Southern California's Marshall School of Business.

To be sure, keeping students happy is important. But now, with the economic downturn likely to deepen, students and corporations alike might think twice about even embarking on an EMBA, with its steep tuition.

Understandably, more than one administrator has a case of the jitters. "Some companies that sponsor students may find themselves just trying to stay afloat," worries Georgetown's Lisa Kaminski, director of the school's EMBA program. But so far, few schools report students dropping out; and applications remain steady. Companies may feel the need more than ever to develop strong senior managers, speculates Howard Kaufold, EMBA director at Wharton. Moreover, notes Lee Dailey, director of executive and management education at United Technologies Corp.: "If you put a stake in the ground and say that education is one of the core values of the company, you can't very well back off when times are bad." Indeed, the worst of times might be a good time to stay the course.

By Jennifer Merritt in New York

Special Report

EXECUTIVE EDUCATION

What Counts in the Ranking

Which Executive MBA programs are the best? That's the question *BusinessWeek* set out to answer in its first ranking of executive MBA programs across the globe in a decade. Since our 1991 ranking, we have published every two years an unranked alphabetical listing of the top programs, based on a poll of EMBA program directors about their rivals. But to develop a ranked list, we added a survey of recent grads of EMBA programs.

We identified 82 schools with EMBA programs that met the three criteria for inclusion. First, the school had to be accredited by the AACSB International, the U.S. accrediting body, or by the European Quality Improvement System (EQUIS), its European counterpart. Schools had to have at least 25 students in the most recent graduating class, and EMBA programs had to be at least four years old.

We enlisted the help of Cambria Consulting Inc. in Boston to help administer our surveys over the Internet. For the student survey, we contacted students from the most recent graduating class in 2001.

We sent a 40-question survey to 5,052 EMBA graduates and got 3,041 replies, for a response rate of 60%.

Grads were asked to answer most questions on a scale of 1 to 5; an answer of 1 meant poor, while 5 was excellent. The questions addressed the students' experience at their schools and focused on everything from teaching quality to level of support services to curriculum flexibility. For the directors' poll, we asked the 82 EMBA program directors for their views on which 10 schools, excluding their own, offered the highest-quality programs. We got 55 responses, for a response rate of 67%.

The surveys of graduates and directors each accounted for 50% of a school's score. We standardized the scores from both polls, adjusted the total to eliminate possible bias against smaller

schools, and added up the scores. Schools with too few grad responses were disqualified. Because most EMBA directors didn't distinguish between a B-school's flagship program and its global offering, we ranked only the main program of each school.

Who Had a Say

	EMBA GRADUATES	EMBA DIRECTORS
NO. SURVEYED	5052	82
RESPONSES	3041	55
RESPONSE RATE	60%	67%

Data: *BusinessWeek*, Cambria Consulting



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IT'S A DIFFERENT KIND OF WORLD.
YOU NEED A DIFFERENT KIND OF SOFTWARE.

You Paid for Grads' Skills. Now Use Them

Last year, Brent Fitch was still in the thick of his studies at Purdue University's Krannert School of Management when he up and left his job as a senior account representative at an auto parts company. The reason: His employer was completely unsupportive of his efforts, he says, making him use up vacation time for the two-week-long executive MBA residence programs, providing scant financial support, and even questioning the worth of the degree.

So Fitch, 37, took his six years of management experience and still-growing business acumen to more welcoming arms. At Denso International America Inc., a Southfield (Mich.)-based auto parts maker, Fitch was able to negotiate a more flexible work schedule, as well as financial support for his degree. Now, as a sales manager, he uses skills learned from the EMBA program, from finance to human resources. The new boss "is really pushing me to come up with real strategies based on what I've learned," he says.

Turns out, there are a lot of Brent Fitches out there. Dissatisfied with career development at their sponsoring companies, more than half of the



course, in tight times, "as companies revisit their funding policies, the student picks up even more of the price tag," says Penny Oslund, director of the University of North Carolina at Chapel Hill's Kenan-Flagler Business School's EMBA program.

Seeking a middle road, many EMBA directors are cautiously rolling out career development initiatives but say the programs are designed to encourage employee retention, not job-hopping. Ultimately, though, the only thing stopping employee flight is the employer. UNC's

Oslund is scrutinizing her alumni's career paths to identify the companies with the best practices. And she's finding that employers with the highest retention rates are those that "really do sit down and talk with prospective students about how the degree will affect their career."

A good example, says Maury Kalnitz, executive director of the Executive MBA Council, is the EMBA selection process at J.P. Morgan Chase & Co. Since 1997, a company-wide steering committee has chosen EMBA candidates based on manager recommendations and talent reviews. Each unit's human resources execs and top managers work with the chosen employees to make sure they're challenged. The firm has sponsored more than 300 EMBA's; last year it sent 40 employees to programs at Columbia, New York University, Wharton, Cornell, and Duke.

The fact is, most employees take on the EMBA intending to stick with their companies. James Valle, a University of California at Los Angeles grad, says a class poll at the start of his EMBA program revealed that 80% of them wanted to stay put. By the end of the second year, the number dropped to 20%. Clearly, companies have a choice: Use EMBA's or lose them—and their valuable new skills.

By Brian Hinde in New York

Special Report

EXECUTIVE EDUCATION

graduates in *BusinessWeek's* 2001 survey say their employers should have more clearly defined how an EMBA degree would affect their career paths. And one-third say they would have liked their companies to offer professional coaching or mentoring throughout the program. No surprise, then, that recent EMBA grads report that anywhere from 40% to 70% of their classmates changed jobs during or after the program.

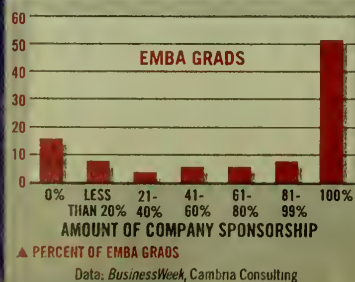
The resounding message for em-

ployers is that they need to improve career development support if they want to hold onto their newly minted EMBA's. Although the shaky economy could keep some employees tethered for now, the vast networking opportunities and high portability conferred by an EMBA degree gives many mid-career grads happy feet.

The schools aren't helping them, either, say grads. Nearly one-third complained that the programs did not offer access to career services offices, and 93% of those would have preferred it. Yet such demands put the schools in a ticklish position. How do the institutions satisfy students' career-planning needs without appearing to encourage job flight? After all, companies foot the entire bill for more than half of all EMBA students at the top 25 schools, according to *BusinessWeek's* survey.

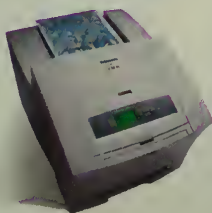
But with 16% of mid-career executives paying their own way at the top 25 programs—a marked increase from 10 years ago, say EMBA directors—the complaints are unlikely to go away. And, of

Footling The Bill
At the top 25 EMBA programs, most students received some funding from their employers



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A Mid-Career Boost

The top 20 nondegree programs for seasoned execs

It takes more than a fancy new name to create a new identity. Certainly, that was the case for Novartis, the pharmaceutical powerhouse created by the \$21.8 billion merger of two Swiss giants, CIBA-Geigy and Sandoz, in 1996. The company's new moniker—derived from the Latin *novae artes*, meaning new skills—was to signal its commitment to research and development.

But that was only the first step. To create a unified corporate culture from this vast, blended family, Novartis packed off more than 500 of its senior executives to Harvard Business School for a five-day customized leadership training program, followed by more sessions in China, India, and Switzerland with the B-school's faculty. "By the end, I felt like I knew what Novartis was," recalls Cynthia Hogan, now a unit vice-president. And, she says, the new cadre of managers got a chance to "put our thumbprint on the company." Now the company, based in Basel, Switzerland, sends thousands of its executives to Harvard and other B-schools for customized programs that stress the home corporation's case studies.

Harvard Business School earns high grades as a favorite purveyor of executive education in *BusinessWeek's* 2001 ranking of the best nondegree mid-career programs. In fact, Harvard tops our biennial rankings for the third time in a row, with many companies citing the school's ability to impart both money-saving ideas and new business strategies. For decades, Harvard has drawn the best and brightest professors and delivered consistent quality of classes and instruction. This year, Harvard is of-



ing 47 open-enrollment executive courses—up from 27 in 1996—for 4,051 execs, and the school's well-regarded Advanced Management Program attracts high-level execs from around the world. The school also has eight new programs abroad in places such as South Africa and China and a wing custom business with 21 corporate clients, vs. just five years ago.

INVESTMENT. Like Harvard, the other schools that stand in the 2001 rankings are adept at creating both custom open-enrollment programs. There's another new trend: schools around the world made a strong showing, with INSEAD, based in France and Singapore, posting No.2. This marks the first time a non-U.S. school has broken into *BusinessWeek's* top five. Respondents advanced INSEAD from No.9 in 1999, lauding its numerous programs abroad and the up-to-date course offerings. What's more, the 2001 survey had the most input from non-U.S. companies ever. Of the 210 that completed surveys, 57% hailed from outside the U.S. Those responses helped carry some of Europe's best schools—such as London Business School, IMD in Switzerland, and Spain's IESE Business School in Barcelona—into the top 10.

In conjunction with Boston-based Cambria Consulting Inc., *BusinessWeek* asked leadership-development directors at a total of 514 companies which executive programs were the best overall and which were the best in such specialized areas as global business, marketing, and leadership. The corresponding findings are on page 112, and detailed profiles of each organization are available online at www.businessweek.com/bschools.

BusinessWeek began ranking executive education programs back in 1991 as more and more corporations turned to business schools to sharpen the leadership and management skills of their executives. Once viewed as a cushy perk for the newly promoted, these programs have become an integral part of corporate strategy—and serious work for participating executives. “Our clients look at this as an investment they want to see a payback,” says Ian Hardie, associate dean for executive education at London Business School.

Schools know that they can't get away with offering rehased MBA classes or one-size-fits-all approaches, especially with tuitions that can reach as high as \$49,000 per student. Corporations are demanding innovative programs such as No.8 IMD's New Ven-

Booster course in which teams of executives do the work to launch new businesses for their own companies. “In a week's time, we can push a project forward by 8 to 10 days that could've been done at work,” says James Ellert, associate dean for academic affairs at IMD.

This year, *BusinessWeek* evaluated more providers than ever—121, vs. the 63 in our last survey, conducted in 1999. In the past 12 months, 159,245 executives attended programs at those schools—a 56% increase since 1996. In addition, revenues from executive education more than doubled in the past academic year, to an estimated \$800 million. The average school's take nearly doubled in that period, from more than \$8 million.

Still, even as Harvard and other B-schools earn kudos for excellence, there are signs that loyalty is beginning to wane. Leadership-development directors at companies increasingly prefer to mix and match programs and professors to suit their executives' needs. “We don't want to be be-

holden to one university, so we have a good collection of partners,” says Gert Stuerzebecher, vice-president of corporate management development at Bertelsmann, the German media giant. Bertelsmann runs programs with INSEAD and London Business School, targeting their top managers and middle-level employees.

Nor are companies relying solely on B-schools to get what they need. A growing number of corporations are designing their own internal training, creating in-house universities to tackle the issues that are most germane to their businesses and executives (page 114). While 56% of respondents say business schools are the most effective at delivering executive education, as many as 62% also work with consultants, and 28% work with other providers of executive education.

STRENGTH IN NUMBERS. In fact, the top-scoring program for leadership development—the Center for Creative Leadership in Greensboro, N.C.—isn't a university at all but a 31-year-old nonprofit organization for leadership development with programs in 22 countries. Its clients include major companies such as General Motors Corp. and Pfizer Inc., and it

Special Report

EXECUTIVE EDUCATION

Who's Tops in Their Field

When it comes to specialties, companies give praise to these programs



CUSTOM PROGRAMS

- 1 IESE
- 2 IMD
- 3 INSEAD
- 4 Center for Creative Leadership
- 5 Harvard

GLOBAL BUSINESS

- 1 INSEAD
- 2 Harvard
- 3 IMD
- 4 Thunderbird
- 5 London Business School

LEADERSHIP

- 1 Center for Creative Leadership
- 2 Harvard
- 3 Michigan
- 4 INSEAD
- 5 Pennsylvania

MARKETING

- 1 Northwestern
- 2 INSEAD
- 3 Harvard
- 4 Pennsylvania
- 5 Columbia

Data: *BusinessWeek*, Cambria Consulting

draws some of its faculty from the world's top business schools. The Center for Creative Leadership, which ranked No.13 overall, is the only non-B-school to make it into *BusinessWeek's* top 20 ranking.

Hoping to stay competitive, the B-schools have scrambled to increase new course offerings, customized programs, and surprisingly, partnerships with their rivals. Among the top five schools in this year's rankings, four have forged alliances with each other in the past six months. The Stanford Graduate School of Business, for example, the No.4 provider of executive education, has teamed up with Harvard to operate all of the schools' custom programs. And the No.5 provider, University of Pennsylvania's Wharton School, has hooked up with INSEAD to create as many as four open programs, including one on international sales-force management.

Sometimes the corporations themselves play matchmaker. Next month, Coca-Cola Co. will bring in Wharton and Emory University's B-school to conduct some joint leadership training. Wharton will offer its financial and global

Special Report

EXECUTIVE EDUCATION

on, Columbia and other B-schools expect to play a role.

Indeed, the more that corporations clamor for relevancy, the more B-schools are offering them custom-tailored approaches, in alliances or from among their own rosters.

"Fifteen years ago, you would have used off-the-shelf case studies on com-

panies," says Jay Conger, a London Business School at University of Southern California B-school professor. "No 60% to 70% of what I do is highly customized." *Business Week's* top 20 schools earned an estimated 43% of revenue through custom work, with programs costing anywhere from \$6,000 at No. 16 Thunderbird to nearly \$6 million at Duke, which ranks twelfth, for a program serving 3,000 executives.

That welcome source of revenue may not be quite bountiful in the months ahead if the economy continues



The Top 20

The best in executive education, according to a global BusinessWeek survey of corporate managers and human resources executives

RANKING/ PROVIDER/ LOCATION	2000-2001 REVENUE MILLIONS	5-YR. GROWTH	OPEN PROGRAMS OFFERED	% FEMALE IN OPEN PROGRAMS	% CUSTOM PROGRAMS*	DESCRIPTION
1 HARVARD Boston	\$91.0**	122%**	47	20%	30%**	New programs in China and Egypt; links with Stanford for custom and Web-based work.
2 INSEAD France/Singapore	47.7	NA	41	15	50**	Tops in global business; exec ed alumni have access to new materials on the Net.
3 MICHIGAN Ann Arbor, Mich.	28.6	61	50	29	16	Offers 30 programs in Hong Kong and Singapore and a supply-chain course on the Web; tops in HR.
4 STANFORD Palo Alto, Calif.	16.0	300	19	16	15	No. 2 behind Harvard in innovation and entrepreneurship; programs for nonprofit leaders.
5 PENNSYLVANIA (Wharton) Philadelphia	43.0	72	43	25	37	Gains global business strength from new INSEAD partnership; tops in accounting.
6 NORTHWESTERN (Kellogg) Evanston, Ill.	30.0	67	31	23	50	New dean considers offering more company-specific mini-MBA programs; No. 1 in marketing.
7 LONDON BUSINESS SCHOOL London	28.6	154	24	22	47	Strong in accounting, global business, and HR; corporate users include IBM and ExxonMobil.
8 IMD Lausanne, Switzerland	46.3	93	21	11	48	Opening a \$15.4 million exec ed center next April; will Webcast to partners in 2002.
9 COLUMBIA New York	18.3	79	23	21	30	Offering new exec programs with London Business School one in Tokyo with Sumitomo.
10 IESE BUSINESS SCHOOL Barcelona	24.0	176	76	24	42	Programs in Spanish or English; tops in custom ranking; strong ties to Boeing and Telefónica.
11 VIRGINIA (Darden) Charlottesville, Va.	22.0	75	23	21	63	Plans more programs in northern Va.; shortening senior-level exec program to four weeks.
12 DUKE/DUKE CORP. ED. (Fuqua) Durham, N.C.	15.0	58	5	23	80	Custom work handled by for-profit Duke Corp. Ed.; new open program on creative leadership.
13 CENTER FOR CREATIVE LEADERSHIP Greensboro, N.C.	49.0	32	13	34	51	No. 1 for leadership with flagship program offered 126 times a year worldwide; No. 4 in custom programs.
14 MIT (Sloan) Cambridge, Mass.	10.4	352	16	15	40	Best in e-commerce; new courses on supply-chain management and Internet business; No. 1 in IT.
15 CRANFIELD Cranfield, England	23.7	86	111	23	63	Offering strategy program with Duke; some courses take lessons from Shakespeare.
16 THUNDERBIRD Glendale, Ariz.	12.8	100	55	30	52	No. 4 in global business; new facility in Archamps, France, to be completed in mid-2002.
17 DARTMOUTH (Tuck) Hanover, N.H.	5.5	199	10	29	11	Exploring partnerships with non-B-schools for custom work; offers programs for minorities.
18 UNC (Kenan-Flagler) Chapel Hill, N.C.	7.9	70	17	45	70	Partners with N.C.-neighbor Center for Creative Leadership to deliver company-specific leadership programs.
19 UCLA (Anderson) Los Angeles	8.0	33	35	30	40	Leadership seminars for women, African Americans, and lesbian, gay, and bisexual managers.
20 CHICAGO Chicago	10.2	1,033	25	26	19	From zero to 25 open programs in five years; courses offered in Chicago, Barcelona, and Singapore.

Rankings were determined by a *BusinessWeek* online survey sent to 514 companies, 210 (41%) of which responded. Companies indicated familiarity with both university and private sector providers and ranked them in order of preference. A No. 1 ranking was assigned 10 points, No. 2 nine points, etc. To compute the rankings, the mean scores were multiplied by the number of companies ranking them and divided by the number of companies that indicated familiarity. Schools ranked too infrequently by companies were disqualified.

*Percentage of total revenue.

***BusinessWeek* estimate.

Data: *BusinessWeek*, Cambria Consulting

Research by Brian Hinds, Mica Schneider, Jennifer Merritt, Jessica Lou

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downward slide. Unlike executive MBA programs, which are reporting little decline in enrollment so far, executive nondegree programs tend to get the ax sooner because they're tied in to companies' training budgets. In tough times, executive sessions can suffer 5% to 20% drops in enrollment as companies cut back on travel and training, according to administrators. Already, some are reporting slowing business as purse strings tighten. At the University of Michigan B-school, for example, revenues have fallen 15% this year, says F. Brian Talbot, associate dean for executive education.

Making matters worse, since the September 11 terrorist attacks in New York and Washington, schools have faced new cancellations and postponements. Michigan has shelved six programs for now. And the future of Harvard's program in Egypt, drawing executives from across the Middle East and Africa, is anybody's guess, admits Richard H.K. Vietor, senior associate dean and chairman of executive education at Harvard.

Still, the business of training executives goes on. Wharton is designing a five-day program for 60 execs this December called Competing in a Completely Changed World. And the Center for Creative Leadership plans a new lecture on how leaders can deal with cultural differences and respond to international crises in light of the attacks. As they respond to their own changing business environment, B-schools are actually practicing the management lessons they preach.

*By Mica Schneider, with
Brian Hindo, in New York*

BusinessWeek online

Look for profiles of more than 280 EMBA and exec ed programs, and tools to help you choose, at www.businessweek.com/bschools.

If It Was Good Enough For Jack Welch...

It was the end of 1999, and John Thornton, co-president and chief operating officer of Goldman, Sachs & Co., was getting some bad news for his top execs. "We're not as good as we need to be," he recalls telling the group of 500 managers and directors. The results of their annual peer reviews had revealed some glaring deficiencies in leadership strength and "development." Not a good thing, he knew, considering that Goldman's worldwide head count would more than double from its 1996 levels in a year through acquisitions and new hires, to nearly 23,000—and strong leaders would be essential to integrate them all.

Goldman had already begun planning a leadership-training operation dubbed Pine Street—named for the original location of the company. But for help refining the concept, and his fellow execs turned to a pro—Steven Kerr, 60, learning officer for General Electric Co. and head of GE's Crotonville, one of the most widely admired corporate organizations. The brainchild of ex-chairman and CEO Jack Welch, the center stresses his notion of a "boundaryless



at shares information and ideas freely and clearly
icates a corporate philosophy from the top down.
April, after Welch announced his retirement, Kerr
ould move on and joined Goldman full time. A for-
school professor at the University of Michigan and
e, Kerr says he'll develop the Goldman training pro-
ng Crotonville lines. "The executives have to get
the guiding principles of Goldman," he says. "Once
pens, I'll shake them up with outsiders' views." But
arned his new bosses not to expect a cookie-cutter
of GE's corporate school—he's not even sure "what
Crotonville" will work. "The longest program at Gold-

man is two days," says Kerr, vs.
three weeks at GE.

COMPANY CLASS. Goldman's
high-profile hire is in keeping
with the growing trend in the
corporate world to beef up inter-
nal leadership education and
training. Of course, companies
are the biggest consumers of ex-
ecutive education provided by
colleges, universities, and pri-
vate-sector institutes. But many
companies—fully 31% of respon-
dents to *BusinessWeek's* execu-
tive education survey—reported
running an in-house corporate
university. "It's more difficult
with business schools to ensure
that you have a cultural fit with
the organization," says Shari

Ballard, vice-president of human resource operations at Best
Buy Co. in Eden Prairie, Minn.

That sentiment worries B-schools, which draw an estimat-
ed \$800 million from their executive programs. As companies
seek out key professors, consultants, and inspirational gurus,
B-schools stand to lose
revenues and clout. To be
sure, the bulk of the busi-
ness still goes to B-schools.

And the schools often take
a small cut of professors' speaking and teaching fees, which
range from \$10,000 to \$150,000 per session, according to
Leigh Bureau, a speakers' agency. Meanwhile, some B-schools
have started to dole out extra payments to entice faculty to
teach in custom exec ed programs the schools run.

Aside from doing his own cherry-picking of favorite profs,
such as Michigan's David D. Ulrich, who teaches organiza-
tional behavior, Kerr is tapping key Goldman execs, including
Chairman and CEO Henry M. Paulson Jr., to lead some ses-
sions. Classwork includes case studies and discussions that
deal with actual situations at Goldman—complete with the
names and business predicaments of current employees.

While it's tempting for companies to sideline training dur-
ing a downturn, Kerr says that's a bad idea. In the works: a
program for up-and-coming managers and a Pine Street fac-
ility in Jersey City by 2003. Goldman is located just blocks
from the ruins of the World Trade Center, and the signifi-
cance of the September 11 tragedy for business leaders isn't
lost on Kerr: "You want leaders to be adaptive," he says.
"You're going to be surprised by the future. That's a fact."
Just what Jack Welch might say.

By Mica Schneider in New York

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JOSE GURU
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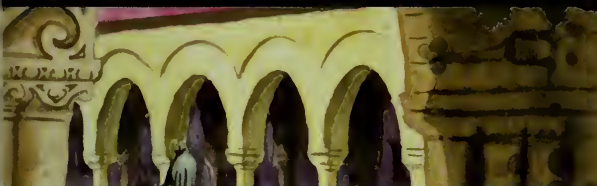
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Viewing Blackouts in a Different Light

Looking at the Crisis in 3-D: Demand, Deregulation and Development

Extensive deregulation and new developments in the power and energy industries, due in part to increasing demand for power, are providing optimism to consumers and creating opportunities for investors. Analysis of these three forces leads to an understanding of tomorrow's power and energy markets and the investment opportunities that exist today.

Demand Intensifies: U.S. consumers are demanding more power. In 1990, computers consumed 3% of the electricity generated in the U.S. Research shows that by 2010 digital technologies could make up 50% of our total usage.* Many businesses are demanding more reliable power as well. When the power at hospitals, airports, dot-com retailers and manufacturing facilities shuts off for even a few seconds, it can be very costly. Power-related downtime in the U.S. costs an estimated \$119 billion annually.

In order to meet our needs, rapid changes are occurring in the power and energy markets. These changes include deregulation and increased development of alternative sources.

Deregulation Encourages Improvements: Power deregulation in many markets across the United States is introducing new competition and leading to the development of more efficient technologies. Many experts believe California's crisis is not a result of deregulation, but the lack of investment in power plants coupled with insufficient deregulation. In the mid-Atlantic region, the deregulated market is working. "There are no brownouts. Power prices have declined and consumers are better off," said Phillip G. Harris, president and CEO of PJM Interconnection, which operates the power grid and wholesale electricity market in a five-state mid-Atlantic region. Planning has already begun on 150 new power plants in this area.** Deregulated markets ultimately provide more choice to the consumer at a lower price. Unfortunately, it takes time to realize these benefits.

Developing Alternatives: Today, many consumers are generating power on location. This trend, known as distributed generation, is driving development of alternative sources and power technologies, such as microturbines, fuel cells, and wind and solar power devices. As a result, these alternatives are becoming dramatically more efficient and economically viable. Twenty years ago, solar power was used to heat water in homes. Today, it generates enough electricity to light entire office buildings. Wind power is more efficient as well, thanks to advances in wind blade aerodynamics. In fact, a new wind farm along the Washington/Oregon border will generate enough electricity to light 300,000 homes.

Hope for a Brighter Future

Due to increasing demand, deregulation and the development of alternative power sources, the power and energy industries are going through a period of accelerated change. While the power crisis may seem bleak to consumers at the moment, there are many reasons for consumers to be encouraged about the future and for investors to be optimistic about the opportunities.

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*Dataquest, October 1999; Raymond James & Associates, Inc. Research, December 2000.

**Harris, Phillip G., "Where Electricity Deregulation Works," Wall Street Journal, May 16, 2001



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FENCING,
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Thrust and Parry, Anyone?

The joys—and health benefits—of learning to fence

BY DAVID WELCH

Last year, during the Summer Olympics, IBM ran a series of black-and-white magazine ads featuring American athletes in urban settings. One showed Aki Spencer El, the top U.S. Olympic saber fencer, in New York. I took up fencing about two years ago, so I cut out the ad and taped it to my office wall.

Imagine my surprise when I looked at the schedule of bouts at the U.S. Fencing Assn. National Championships in Sacramento this past July and saw that Spencer El would be my opponent. Such is the nature of American fencing that even at the nationals, marginal swashbucklers like me can end up dueling an Olympian.

Beating one is quite another matter. By fencing

twice a week, I've kept in good shape and gained some sense of balance. Slowly, I'm developing the moves and strategies that will win "touches"—points, in fencing parlance. I scored the first touch of the bout on Spencer El and let him know it with some exuberance. Then he rattled off five touches in rapid succession, dispatching me to the showers before I knew what hit me.

Fencing is not an easy sport to learn. It requires tricky footwork, leg strength, poise, and balance. Different fencing schools start

trainees off differently. My club, Renaissance Fencing in Madison Heights, Mich., put a focus on my hand after I took two lessons a week for about a month. A foil, with its thin, malleable blade, is the piece of equipment most nonfence-

HEALTH FITNESS



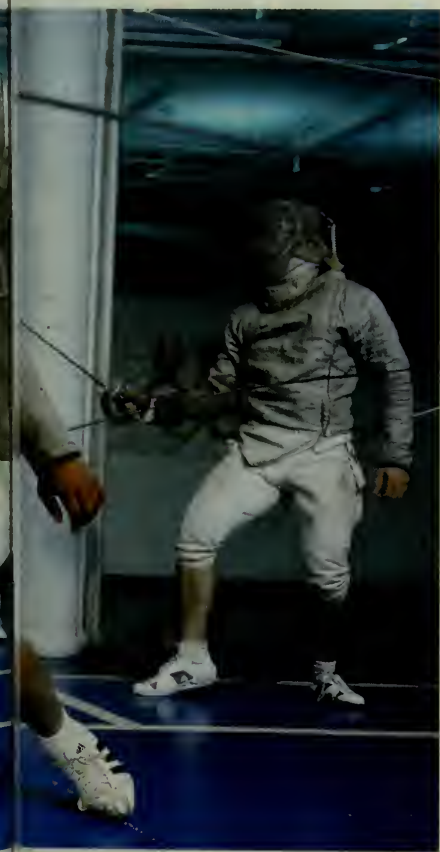
ciate with the sport. Spencer El's trainer, r Westbrook, who gets disadvantaged ur-kids off the streets by teaching them fencing ie Peter Westbrook Foundation in Manhat-says he gives his neophytes a sword at the nd lesson.

ost clubs spend a month or two showing the basics before any real swordplay hap-. During that time, you go through the ling process of learning fencing footwork. more strenuous than a few repetitions of oing iron, or a short all-out sprint. Imagine footwork of boxing, except you never really l up straight, and you can't let your back cross in front of your forward foot.

ie en garde position—which is the stance ers keep throughout a bout—is tough to tain at first, and puts a constant strain on thigh and calf muscles. It requires you to ally squat with your shoulders squared up to your opponent. You aim your front leg ght forward and your trail leg, which should uarely under you, between 45 degrees and grees from the front leg.

—AND-START. The early classes were tough ise fencing is so different from the sports I up playing. In baseball and basketball, I aught to lean forward in an attack position. ncing, you keep your shoulders back.

at once you get the basics, fencing is a great sion. With its stop-and-start pace, the work-s about as taxing as tennis. Fencers move and forth quickly, setting up their oppo-to launch a failed attack or to open the



WESTBROOK: “Saber fencers are a little more wild-spirited”

target for their own attack. Since even the best fencers give up touches, you can have a lot of intense bouts where every point counts.

Each one of the weapons—foil, épée, and saber—has its own personality. The foil, used only as a thrusting weapon, is the most popular. Since its one target—the torso—is small and you can only score with the tip, foil fencers move gracefully to set up their opponent for a touch. Westbrook compares foil to ballet.

Épée is a more classic dueling weapon. The target extends from head to toe, and the blade hardly bends. Since even tapping the épée point on the wrist scores a point, épée fencers have to calculate their moves so they don't get hit while launching an attack. The action is not as fast as with the other weapons, but involves a lot of strategy.

Saber fencing, which is my choice, has the most violent action. The target is from the waist up, and it's the only weapon that can score a touch with its point or edge. Saber fencers wear a lot of bruises, despite their layers of protection. A saber bout is as close as fencing gets to the Errol Flynn-style swordplay we've all seen in the movies. “Saber fencers are a little more wild-spirited, a little crazy,” says Westbrook.

Fencing starts out pretty cheap. But costs can climb quickly. Introductory lessons range from \$150 to \$250 for about two months of twice weekly classes. A starter set of equipment, which includes a foil, jacket, and mask, costs about \$140. Most clubs will lend novices equipment, so you don't have to buy anything until you're sure you want to stick with it.

The big bucks come into play when you graduate to more advanced levels. Foil and saber fencers wear electric jackets connected by a cord to the score box; in épée bouts, only the sword is wired. When your opponent's blade hits your jacket, the score box sounds off the touch. Competition equipment—including protective jacket, knickers, weapon, and electric jacket and mask—can be had for as little as \$300. But first-rate garb and weaponry can run \$1,000. You also have to factor in a club membership for \$50 to \$100 a month and lessons at \$25 to \$50 an hour.

In my view, if you like one-on-one competition and can enjoy the romance of sword fighting, fencing is worth every penny—even if you never get the chance to score a touch on an Olympian. ■

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FENCING.NET

www.fencing.net

Provides interesting background and history; links to fencing clubs and equipment suppliers

UNITED STATES FENCING ASSN

www.usfa.org

Offers good introductory information about the sport and competition schedules; also has links to clubs that teach beginners across the U.S.

Get Fit on the Web

Personal training without the price tag

BY
DOUGLAS ROBSON

Patty Kennedy was using a personal trainer four times a week when injuries from a car accident forced her onto the sidelines. By the time the Charlotte (N.C.) resident returned to the gym, her trainer was booked, so she decided to go it alone. But something was missing. "I needed more structure," says the 42-year-old ultrasound technician.

That's when she discovered MyFitnessExpert.com, one of many Internet sites offering personalized fitness instruction. The site designed a program for her based on her vital health statistics, workout history, and fitness goals. Now, Kennedy can chart her progress or revise her workout routine online on a daily, weekly, or monthly basis. She also can contact by e-mail the cybertrainer assigned to her for follow-up questions. "It's very personal," says Kennedy, who has used the site for six months. "I'm managing my weight, I've been able to build strength, and I'm training for a marathon."

Web accessibility is drawing more people to "virtual" trainers as an alternative to training alone or working with a fitness instructor. One reason: Personal trainers charge \$30 to \$150 an hour, while an online service usually runs a few dollars a month. Web training is also more flexible since you don't have to meet at a certain time and place. And it's ideal for people who want expert advice but don't need hand-holding. "I like to work out by myself, and I can get everything from the Web site," says Doug Gotelli, 43, a salesman for Tyco Electronics in San Jose, Calif., who has been using Workout.com for about a year.

Superior sites offer videos showing proper form

and the sequence of exercises. They also provide recipes based on a person's diet and preferences. Many also offer feedback from experts, usually within 24 to 48 hours, on everything from training while pregnant to injuries. Some send the user daily e-mail prescribing that day's exercises, reps, sets, and weight amounts, or specific cardiovascular routines. Many users simply download information to their laptops or print out routines to carry with them to the gym.

CHECK CREDENTIALS. The Web can't completely replace personal training. And experts warn that, as with online dating, it's hard to know if the information you're getting lives up to its billing. "Anyone with a good rap and a nice photo" can set up shop electronically, says Gregory Flaherty, founder of FitAdvisor.com and a spokesman for the American Council on Exercise (www.aace.org), the nation's largest accreditation organization, with some 50,000 members.

Lack of regulation remains a serious problem in the fitness industry, both online and off. So important to check credentials, says Ken Romano, executive director for ACE. The sites usually list bios and name some of the professional designations that qualified pros have. You

should review their mail for more information. Ask to talk to clients. Credentials also be vetted via other groups, such as the American College of Sports Medicine (www.acsm.org) and the National Strength & Conditioning Assn. (www.nsc.org). All keep records of members.

It takes motivation and ample discipline to make online training work. But combine those attributes with right virtual training, and you yield very real results.



Comparing the Sites

WEB SITE (WWW.)	COST	COMMENTS
FITADVISOR.COM	\$71 per year	Exercise experts available by e-mail and phone
FITSITE.COM	\$49.99 one-time fee \$25 to update programs	Trainers customize programs based on your inputs
GLOBALFITNESS.COM	\$59.99 per year	Some 30 fitness, nutrition, health experts on call
GOLDSGYM.COM	\$34.95 per year for non-Gold's members	Best among the big chains, but limited personalized instruction
MYFITNESSEXPERT.COM	From \$19.95 per month	Assigned personal trainer designs your program
MYWORKOUTPARTNER.COM	\$19.95 per month	Alters your personal program every eight weeks
WORKOUT.COM	\$35.40 for new members	600 exercises, with video instruction

Colon Cancer: An Easier Diagnosis

new "virtual colonoscopy" may get more takers

CAROL MARIE
PPER

If you're 50 or older, your doctor has probably started to nag: Get screened for colorectal cancer, second only to lung cancer as a cause of cancer deaths in the U.S.

Trouble is, the most thorough way to check for cancers and the polyp growths that can turn into them—a colonoscopy—involves an extremely uncomfortable bowel cleansing one day, followed by sedation and a look through your colon with a five-foot-long probe the next. Not surprisingly, many people pass. Only about a third of those over 50 have had any type of colorectal cancer screening. That's a shame, since 90% of such cancers can be prevented—and half of those who wait until they have symptoms will die.

Fortunately, a test that may be almost as effective but far less invasive is becoming an option. Many doctors are offering a "virtual colonoscopy," a new and still experimental screening test that could one day make the hated colonoscopy unnecessary for most people. Also called CT colonography, the procedure involves moving the patient through a computed tomography (CT or CAT) scan machine to produce hundreds of visual slices of the abdomen. Software can then transform those slices into a virtual trip through the colon, leaving the doctor with a computerized version of what he might see through a colonoscope, the lighted fiber optic tube used in conventional colonoscopies.

So far, studies suggest that a virtual colonoscopy can approach the efficacy of the conventional test in finding cancers (virtually 100%) and large polyps (about 94%). But Dr. Joel Fletcher, a diagnostic radiologist at the Mayo

Clinic in Rochester, Minn., says more studies are needed before virtual colonoscopy can become routine.

Michael Brady, a 62-year-old health-care consultant from Chicago, can attest to the ease of the virtual colonoscopy relative to the actual one. The laxative he used to prepare for the virtual test was far milder, not requiring a rush to the bathroom every few minutes as the one for his conventional test did. He also didn't need sedation, and the CT procedure took about 30 minutes, vs. three hours for the regular test. A patient might miss a couple hours of work rather than a day or two for the conventional test.

In Brady's case, the virtual colonoscopy yielded a dramatic extra benefit. Because his entire abdomen was scanned, doctors at the University of Chicago Hospitals were able to see his abdominal organs as well. They spotted a lime-sized tumor on his left kidney, which was later removed. "The virtual colonoscopy certainly could have saved my life," Brady says.

THEN AND THERE. But Brady also got first-hand experience with virtual colonoscopy's big drawback: About 10% of those who take it will need to follow up with the conventional procedure to deal with polyps discovered. With the old test, polyps can be removed immediately with tiny tools operated through the colonoscope. Since Brady had intestinal polyps, he had to return.

Another disadvantage: Since virtual colonoscopies aren't an accepted screening test, your insurance isn't likely to pick up the \$650 to \$1,000 tab. A regular colonoscopy can run up to \$2,000, but it's more likely to be covered.

Also, because the virtual test is new, patients should seek an experienced medical center, says Dr. Abraham Dachman, director of the CT department at the University of Chicago, which is one such facility.

More established options to colonoscopy: Stool samples can be checked for blood, barium enemas allow X-rays of the large intestine, and a sort of mini-colonoscopy, called a sigmoidoscopy, examines the lower colon. But a consensus is growing that these are far less effective in detecting cancers and polyps than a colonoscopy. So a virtual test may turn out to be the next best thing. ■



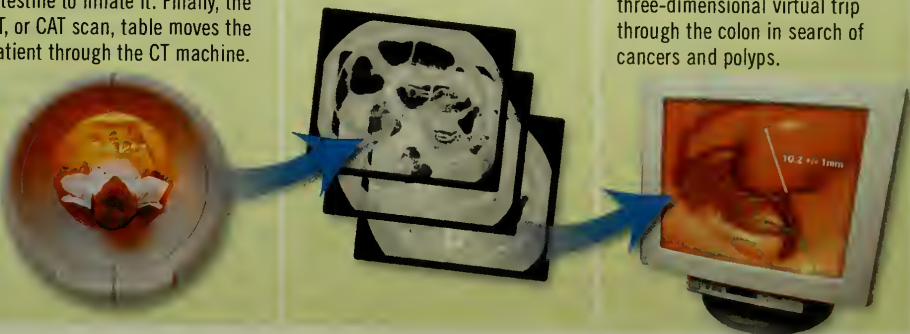
How It Works

Colonoscopy is the most thorough way to look for colorectal cancer and the polyps. But many Americans avoid the unpleasant, pricey procedure, which insurance may not cover. Doctors say "virtual colonoscopy" is a possible alternative.

STEP 1 The patient prepares by cleansing the bowel. Then, carbon dioxide is pumped into the large intestine to inflate it. Finally, the CT, or CAT scan, table moves the patient through the CT machine.

STEP 2 The machine takes hundreds of visual "slices" of the patient's colon.

STEP 3 Computer programs make it possible to meld the two-dimensional CT images into a three-dimensional virtual trip through the colon in search of cancers and polyps.



PHOTOGRAPH (LEFT) MAXIMILIAN STOCK LTD/SCIENCE PHOTO LIBRARY/PHOTO RESEARCHERS INC. (RIGHT) 2) VIATRONIX, INC. DIAGRAM BY LAURAL DAUNIS-ALLEN/BB

A NEW LOOK AT
INSIDE TRADING,
HEALTH-RELATED
STOCKS

BusinessWeek Investor



A Cure for Anemic Portfolio

In good times and in bad, drugmakers and hospitals thrive

BY LEWIS BRAHAM

If you're feeling sick about the bear market, you could take two Tylenol and hope for a recovery. Or you could buy shares of Tylenol's manufacturer, Johnson & Johnson. Health-care stocks often outperform during periods of economic stress. Unlike such sectors as gold or food, which prosper mainly in recessions, health care also thrives in boom times. Four of the 10 top-performing mutual funds over the past 15 years specialize in health care.

Why the resilience? People may forgo vacations and fancy dinners during a recession, but they don't stop taking their medication. "Most drugs and medical procedures are not discretionary," says Frank Sustersic, portfolio manager of the Turner Healthcare & Biotechnology Fund. "They're very necessary." Moreover, demographics favor health care. According to the U.S. Census Bureau, the percentage of Americans over age 65 should rise from a current 12.5% to 20% by 2030. "That's the slice of the population that accounts for 40% of health-care

expenditures," says Robert Gold, a health-analyst at Standard & Poor's.

Even with the bright prospects, health-stocks still get pummeled if overvalued. Indeed the sector is down 14% so far this year (which still beats the 21% decline in the Standard & Poor's 500-stock index). According to Turner Sustersic, health stocks have historically traded at a forward price-earnings ratio (based on projected earnings for the next 12 months) that is 40% higher than the S&P 500's average. The average stock in the S&P Health Care Index has a 23.7 2002 p-e, compared with the S&P 500's 17.7, a lofty 33.9% premium. But the premium is likely overstated. That's because earnings of other sectors will fall more than those in health care. That will raise the S&P 500's p-e, bringing it closer to that of the health-care index.

TOUGH TIMES. Yet resiliency is not immune. "Health-care profits don't decline during a recession," says portfolio manager Samuel L. of the Eaton Vance Worldwide Health Science Fund, "but their growth slows down." In

tough times induce patients to seek less expensive substitute drugs or procedures, squeezing profit margins. A good example is Merck's Vioxx, an arthritis drug that's pricier but has fewer side effects than competing "super-aspirin" drugs. "Merck thought Vioxx would sweep this drug class," Isaly says, "but the acceptance rate has been lower than expected because of its higher price." So, Merck recently had a profit warning.

The best companies offer either niche drugs or products that are vastly superior to their peers'. Isaly points to Novartis, which recently received Food & Drug Administration approval to sell Gleevec, a drug to treat chronic myeloid leukemia. "This drug works where nothing else does," says Isaly, "so Novartis can price it at a hefty premium." Another example is Pfizer's new Geodon, which is much more effective and has fewer side effects than competing schizophrenia drugs, says Michael Dauchot, portfolio manager of Dresdner RCM Global Healthcare Fund. "We think Geodon could capture 20% of the \$3 billion-a-year market for schizophrenia drugs."

CHEAPER YET. To search for health-care stocks, you can use *BusinessWeek's* online screener. Simply go to businessweek.com/investor/stocks.html and look for "Investing Tools." Click on "Stock Screeners" and then "Advanced Stock Search." Under "Select An Industry," click on "Drugs." By setting pany/s&P Growth Ratio" to a minimum of 0.5, you ensure that no drug-stock pick has a for-p-e more than 40% higher than the s&P (if you want cheaper stocks, raise the min-ratio to 0.8 or 0.9.) Also, set a minimum of 0.5 for "Proj EPS Next FY"—or projected earner share for the next fiscal year—and the for "Proj EPS Annualized 5 Yr." That allows you to find companies with the highest earnings rates. Stocks that make the cut include Teva Pharmaceutical, Pfizer, and Pharmacia.

The screener pulls up some biotechnology stocks, too—but only profitable ones. Most health companies are small and have undeveloped or fledgling product lines. They often need cash to stay afloat; that capital has dried up in the slowdown. "Only about 20 biotech companies are currently making money off new product lines," says Isaly. "They don't have any capital problems, but the ones that are not, we avoid." Of the profitable ones, the favorite is Genzyme, which makes Renagel, a kidney dialysis drug.

Many certain unprofitable biotechs are so beat-up that some think they're buys. Dresdner's fund is accumulating shares in Abgenix, Genentex, and Protein Design Labs, antibody manufacturers all down more than 50% this year. The companies are trading at two times book value, which has historically represented their fair value, he says. Scarce capital could also make them acquisition targets. "The shortage will force them into the arms of larger drug companies, which can fund and market their prod-

ucts," says Sam Stovall, S&P's sector strategist.

One health industry that has held up well this year is hospitals, with the average stock up 8%. "Medicare and commercial health insurers are giving hospitals significant rate hikes, on average around 8% in 2001 and 2002," says S&P's Gold. Gold gives hospital giant Tenet Healthcare five stars, S&P's highest rating. "Tenet has been going through a restructuring for the last two years, selling underperforming hospitals and acquiring ones in California, Florida, and Pennsylvania, which are heavily populated by the elderly," he says. Gold also rates HCA, the largest hospital company, five stars.

Medical-equipment stocks also hold promise, but it is hard to generalize about this industry. "Device companies cater to particular niche areas of health care," says manager Michael Yellen of the Aim Global Health Care Fund. "If their niche does well, they do well." Industry leader Medtronic focuses on pacemakers and defibrillators, which have higher profit margins than other devices, such as blood and plasma products manufactured by Baxter International. So Medtronic deserves a higher p-e than Baxter.

Stocks of HMOs and nursing-home operators have performed relatively well this year, but some managers are wary of them. "HMOs have increased their premium rates at double digits during the past couple of years," says Yellen. "Now that the economy is slumping, their corporate clients are pressuring them to bring those rates down." Nursing homes are reeling from cutbacks in Medicaid payments.

Still, the majority of health-care companies look robust right now. "Our portfolio should have a 15% earnings increase this year, while earnings for the S&P 500 will likely decline," says Isaly. "Yet our fund is down 15% in 2001." Such divergences won't last forever. At some point, the health-care stocks will catch up with their superior earnings growth. Then, if you own them, you won't need any Tylenol. ■

Stocks

Health stocks tend to have higher p-e ratios than other stocks, but the sector usually holds its own during a downturn

Good For Your Financial Health

STOCK/SYMBOL	INDUSTRY	PRICE*	PRICE-EARNINGS RATIO*	ESTIMATED EARNINGS GROWTH RATE*
ABBOTT LABORATORIES ABT	Drugs/Med. Eqpt.	\$50.99	22.7	12.7%
BAXTER INTERNATIONAL BAX	Med. Eqpt.	55.05	27.3	13.6
BAYER BAYZ	Drugs	29.00	13.8	5.5
GENZYME GENZ	Biotechnology	46.60	31.5	23.1
HCA HCA	Hospital	44.22	19.8	14.8
JOHNSON & JOHNSON JNJ	Drugs/Med. Eqpt.	54.48	25.0	13.1
MEDTRONIC MDT	Med. Eqpt.	42.57	30.0	17.1
NOVARTIS NVS	Drugs	38.75	22.7	10.8
PHARMACIA PHA	Drugs	40.06	19.9	16.6
PFIZER PFE	Drugs	39.75	25.0	20.2
TENET HEALTHCARE THC	Hospital	60.00	21.1	15.8
TEVA PHARMACEUTICAL TEVA	Drugs	59.51	25.1	24.1

*As of Sept. 27 **Based on 2002 estimates ***Five-year estimate

Data: First Call Corp., Morningstar Inc.



We share the pain and grief of all Americans in the aftermath of the vile attacks of September 11. We extend our condolences to the families and friends of the victims and to the American people.

We watched the daunting rescue operations and we admired the courage of those who have been working for days and nights through the rubble to save one more life.

The Turkish people who have long suffered the terrible consequences of random violence and terror directed against innocent civilians, understand and condemn the full horror of the events of September 11.

May the victims rest in peace and may their memory guide us towards a peaceful world.

TÜSİAD

TURKISH INDUSTRIALISTS' AND BUSINESSMEN'S ASSOCIATION

INSIDER TRADES: TAKE A CLOSER LOOK



ROBERT BARKER

businessweek.com

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indicates that
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profit declines
in years, not
months, before
fact—and
sell their shares
in good times

Uncertainty on Wall Street can grow or shrink moment to moment. But this much stays constant: As a group, corporate insiders—mainly top executives and directors—beat the market when buying and selling stocks of their own companies. That's why a whole sub-industry is devoted to tracking and interpreting the trading reports insiders are supposed to make to the Securities & Exchange Commission. With the Web and the spread of sites (including BusinessWeek Online) posting free insider-trading data, it's a snap for individual investors to clue in to what insiders are up to.

But are we cluing in to the right data? A "window" of insider trades, spanning the past 3, 6, or 12 months, is what popular personal-finance spots on the Web, including pages featured by America Online and Yahoo!, typically focus on. Now, new research suggests insiders begin dumping stock over two years before a company's earnings fall. If more research bears out and broadens this finding, investors may need to rethink how they assess insiders' moves.

Researchers Bin Ke and Steven Huddart of Pennsylvania State University and Kathy Petroni of Michigan State University note that despite vast evidence of insiders' trading beating the market, there is little academic research explaining just what insiders know before the rest of us. For instance, they wondered, do insiders correctly anticipate declines in companies' profits? To find out, they looked at 3,952



intense selling, and it started even earlier. Insider sales of growth stocks on average shot up 11 quarters before the decline in profits (chart). At its peak, four quarters before a break in profit gains, insider selling in growth stocks nearly quadrupled its usual rate. "The longer the string [of profit gains], the more evident is the insider selling. And insider selling is higher prior to long breaks" in profit gains, Huddart told me. "Insiders as a group know a long time in advance when their corporations are going to suffer an earnings drop."

WHO KNEW? If this inference is correct, do these trades cross the boundary into illegal insider trading? The researchers do not assert that, and regulators are not anxious to paint bright lines around what makes

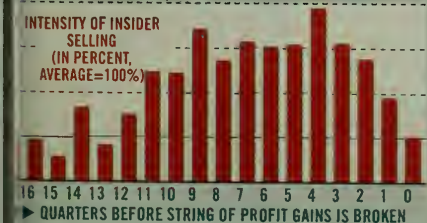
an illegal trade. As an SEC spokesman put it to me: "We're not going to tell people how far back we look or don't look." Less scandalous explanations exist. Instead of relying on hard, "material" inside information about, say, a sudden drop in sales—one hallmark of illegal trades—insiders are as likely to be acting on "soft" information, says University of Michigan finance professor H. Nejat Seyhun, a longtime leader in insider-trading studies. Examples might include a gradually narrowing technological lead or the onset of new competition—slow-moving trends, in other words, that an alert outsider also might exploit.

More and more, courts are having to sort out the propriety of insider trading cited in private lawsuits. One prominent example is Cisco Systems. Among other charges, multiple suits filed this year allege that insiders knew Cisco had trouble ahead yet began selling \$595 million in stock, at prices above \$80, 18 months before the shares cracked in February. Cisco shares are now trading below \$12. A Cisco attorney told me the suit has no merit, cast doubt on the reliability of the \$595 million figure, and added: "We are going to defend ourselves vigorously."

What should you do? Defend yourself, too. Before you trade, check what the insiders have been up to. Keep clicking and scrolling to see the record over the past few years. (You might start at www.nasdaq.com. After getting a stock quote, you can click on the "Holdings/Insiders" link.) Insiders don't emit perfect buy and sell signals. But it's beginning to look as if they are far more prescient than we had imagined.

Farsighted Insiders

Insider selling at growth companies intensified nearly three years before profit growth faltered



companies that from 1994 to 1997 broke a string of quarterly profit gains. Had insiders dumped stock before the break in profit gains?

They did, often and early. Insider selling, the researchers discovered, jumped markedly above its average level as early as nine quarters before a break in profit increases. Stocks of growth companies saw more

BusinessWeek online

For barker.online, go to www.businessweek.com/investor/ and click on "Columns"

Data: Bin Ke and Stephen Huddart, Pennsylvania State University, Kathy Petroni, Michigan State University

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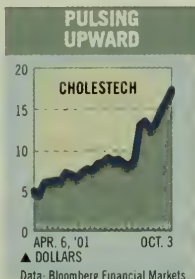
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Chico's FAS is
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Sometimes, a stock is such a secret that even Wall Street is kept in the dark. Take Cholestech (CTEC), an up-and-comer in diagnostic testing that has no analyst coverage as yet. More than a defensive play, this may be a chance to get the jump on some promising growth. Cholestech has a device—smaller than a toaster—that measures “good” and “bad” cholesterol, using just a pinprick of blood rather than the usual vial. Results are available at the doctor's office in five minutes, while standard tests require a week's wait.

The shares have soared from 3.68 in March to a 52-week high of 18 on Oct. 3. The jump was powered by record revenues of \$12.4 million—up 35% from a year ago—for the fiscal first quarter through June. Profits rose 13% in the same period. A National Institutes of Health announcement of cholesterol-testing guidelines in May also played to Cholestech's strengths.

In April, William Burke, a Bear Stearns investment banking veteran, became chief financial officer—and has talked up Cholestech to institutional investors. “If this is the beginning of institutional inflows and more coverage, it could be a big step,” says Mathew Arens of Kopp Investment Advisors, which owns 1.6 million shares, or 13% of the company.

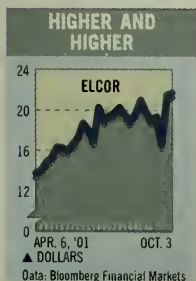
With a new production line, Arens sees 25%-a-year sales growth—which “will definitely translate to earnings”—and he expects the price to double in a year. Arens adds that Cholestech, a micro-cap company at \$200 million, may be buyout bait for a medical-device outfit such as Boehringer-Ingelheim or a drugmaker like Pfizer, which already has a \$7 million testing contract with Cholestech and a big roster of cholesterol-lowering drugs.



ELCOR'S FACTORIES ARE HUMMING

Elcor (ELK) is a two-trick pony. Its Cyber-shield unit—which makes coatings for cell phones that reduce the electromagnetic pulses close to users' heads—was all the rage during the telecom boom. But the stock plunged by half in May, following a warning that fiscal 2000 and 2001 earnings wouldn't meet forecasts.

Luckily, that's only a small piece of the Dallas company's business. Elcor also makes shingles for roofing and coatings for engine parts, and those operations are flourishing. Elcor recently announced that earnings would beat analysts' estimates: The company ex-



pects 27¢ to 32¢ per share for its first quarter, 2002, ended Sept. 30, vs. the consensus 19¢. The stock, trading at 21, is up 27% so far this year. A new \$75 million factory in Meyerstown, Pa., will serve a growing Northeast market, says John Kasprzak of BB&T Capital Markets in Richmond, Va. “Further upside surprises are likely, and that's what's going to drive the stock higher,” he says.

Kasprzak had initially predicted that the new plant would be profitable by June, 2002—but it is already in the money. He says it will ultimately contribute more than \$2 a share to yearly earnings. In the meantime, he has raised estimates for fiscal 2002 to \$1 a share, up from 45¢ in 2001. Falling prices for oil, a big production cost, will help, he adds. Dwain Carryl at equity-researcher Sidoti in New York, who rates Elcor a “buy,” sees the stock hitting 28 in a year.

STILL LOOKING CHIC AT CHICO'S

Retail stocks have been hard hit lately—with the Standard & Poor's Retail Stores Composite down 10% in the past three months. But some clothiers are dressed for success. Chico's FAS (CHS) targets women who favor stylish yet comfortable outfits. The company, which spends more on employee training than rivals do, boosts sales with on-site shopping parties and club programs. On Sept. 4, the stock hit a 52-week high of 39, having tripled in 2001. Since then, it has taken a sharp tumble. Before the retrenchment, Chico's 255 U.S. stores boasted big increases: For the 26 weeks ended Aug. 4, net sales were up 56%, and profits more.

But just as investors have bid Chico down on anticipated weaker sales, analysts are trimming their forecasts. Jennifer Black of Wells Fargo Van Kasper has dropped her 2001 estimates from \$1.88 a share to \$1.43 and expects flat to slightly negative results for the year—a minor glitch compared with “some other pretty nasty same-store sales out there,” she says. Nevertheless, she says, “we think the stock is going to rock.” Her near-term price target is 48.

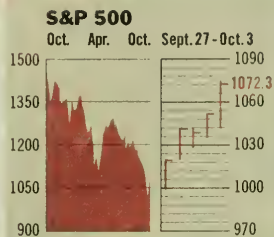
Richard Driehaus of Driehaus Capital Management says Chico's is one of the best-positioned specialty retailers, serving those with the highest discretionary income. “The markets are overreacting on a short-term basis,” he says. Chico's has “a good underlying matrix, even though the growth rate may slow down.”



BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:10 p.m. EST on CNNfn's *The Money Gang*.

Stocks



COMMENTARY

The Federal Reserve cut rates and the market surged. For the week, the Dow Jones Industrials and the S&P 500 index each rose 6.5%, while the tech-heavy Nasdaq climbed 8.0%. Indeed, the Nasdaq soared 88.4 points, or nearly 6%, in just one day on Oct. 3. Leading the charge were bellwethers Microsoft, Intel, and Oracle, while Net giant Cisco powered ahead 20%.

Data: Bloomberg Financial Markets
Bridge Information Systems, Inc.

U.S. MARKETS

	Oct. 3	Week	Year to date	Last 12 months
S&P 500	1072.3	6.5	-18.8	-24.8
Dow Jones Industrials	9123.8	6.5	-15.4	-14.9
Nasdaq Composite	1580.8	8.0	-36.0	-54.3
S&P MidCap 400	442.4	6.8	-14.4	-15.4
S&P SmallCap 600	197.4	5.9	-10.1	-6.9
Wilshire 5000	9842.5	6.4	-19.2	-26.4

SECTORS

	Oct. 3	Week	Year to date	Last 12 months
BusinessWeek 50*	717.6	7.3	-26.0	-37.8
BusinessWeek Info Tech 100**	353.3	6.8	-37.5	-57.4
S&P/BARRA Growth	544.3	6.0	-20.8	-32.9
S&P/BARRA Value	528.1	7.0	-17.0	-16.5
S&P Energy	791.1	9.3	-15.1	-16.7
S&P Financials	142.0	7.6	-13.8	-13.3
S&P REIT	88.4	-0.2	0.5	5.6
S&P Transportation	587.6	9.0	-15.8	-1.3
S&P Utilities	263.8	9.9	-24.8	-21.3
GSTI Internet	78.2	9.6	-57.0	-79.4
PSE Technology	544.0	7.5	-33.2	-45.6

*Mar. 19, 1999 = 1000 **Feb. 7, 2000 = 1000

BEST-PERFORMING GROUPS

	Last month %
Defense Electronics	33.5
Metal & Glass Containers	15.0
Insurance Brokers	14.7
Gold Mining	9.8
Regional Telephone Cos.	7.7

WORST-PERFORMING GROUPS

	Last month %
Engineering & Constr.	88.3
Tobacco	63.6
Pollution Control	54.9
Toys	41.0
Specialty Printing	40.0

GLOBAL MARKETS

	Oct. 3	Week	Year to date
S&P Euro Plus (U.S. Dollar)	956.7	3.5	-3.8
London (FT-SE 100)	4881.8	4.0	-2.1
Paris (CAC 40)	4024.3	1.2	-3.1
Frankfurt (DAX)	4436.7	8.3	-3.1
Tokyo (NIKKEI 225)	9924.2	2.9	-2.1
Hong Kong (Hang Seng)	9897.1	6.6	-3.1
Toronto (TSE 300)	6903.8	3.7	-2.1
Mexico City (IPC)	5407.5	1.6	-1.1

FUNDAMENTALS

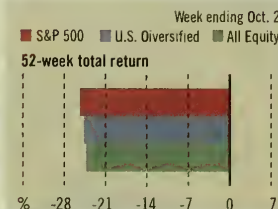
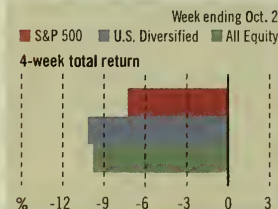
	Oct. 2	Wk. ago
S&P 500 Dividend Yield	1.47%	1.53%
S&P 500 P/E Ratio (Trailing 12 mos.)	34.6	33.1
S&P 500 P/E Ratio (Next 12 mos.)*	19.5	18.6
First Call Earnings Surprise*	-0.75%	2.05%

*First Call Corp.

TECHNICAL INDICATORS

	Oct. 2	Wk. ago
S&P 500 200-day average	1227.0	1235.0
Stocks above 200-day average	35.0%	27.0%
Options: Put/call ratio	0.69	0.86
Insiders: Vickers Sell/buy ratio	2.90	3.00

Mutual Funds



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-week total return	%	52-week total return	%
Leaders		Leaders	
Precious Metals	6.3	Precious Metals	23.0
International Hybrid	-3.8	Real Estate	9.9
Domestic Hybrid	-4.7	Small-cap Value	2.0
Financial	-4.8	Mid-cap Value	1.4
Laggards		Laggards	
Technology	-20.7	Technology	-63.6
Latin America	-17.0	Communications	-57.6
Diversified Emerging Mkts.	-14.7	Mid-cap Growth	-42.5
Small-cap Growth	-14.5	Japan	-42.0

EQUITY FUNDS

4-week total return	%	52-week total return	%
Leaders		Leaders	
Rydex Dynamic Vent. 100	44.3	Potomac Internet Short	229.1
ProFunds UltraShort OTC	44.1	Rydex Dynamic Vent. 100	205.3
Prudent Bear	25.3	ProFunds UltraShort OTC	192.2
Rydex Arkots Investor	21.1	Rydex Arkots Investor	116.3
Laggards		Laggards	
Firstar Bal. Gr. Instl.	-60.9	ProFunds UltraOTC Inv.	-92.4
American Heritage	-41.7	Berkshire Focus	-90.0
Van Wagoner Post Venture	-36.4	Berkshire Technology	-89.9
Van Wagoner Emerg. Gr.	-36.3	Van Wagoner Post Venture	-87.2

Interest Rates

KEY RATES

	Oct. 3	Week ago
MONEY MARKET FUNDS	2.97%	3.03%
90-DAY TREASURY BILLS	2.22	2.38
2-YEAR TREASURY NOTES	2.75	2.80
10-YEAR TREASURY NOTES	4.48	4.65
30-YEAR TREASURY BONDS	5.30	5.50
30-YEAR FIXED MORTGAGE†	6.51	6.67

†BankQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 31% federal tax rate.

	10-yr. bond
GENERAL OBLIGATIONS	4.04%
TAXABLE EQUIVALENT	5.86
INSURED REVENUE BONDS	4.26
TAXABLE EQUIVALENT	6.17

THE WEEK AHEAD

EXPORT-IMPORT PRICES Thursday, Oct. 11, 8:30 a.m. EDT ► Import and export prices in September are both expected to have fallen 0.2%. That's according to the median forecast of economists surveyed by Standard & Poor's MMS, a division of The McGraw-Hill Companies. In August, import prices slipped 0.1%, while export prices declined 0.2%.

RETAIL SALES Friday, Oct. 12, 8:30 a.m. EDT ► Retail sales probably dropped 0.9% in September, after rising 0.3% in

August. Excluding autos, sales likely posted a smaller 0.5% decrease, after a 0.5% gain in August. Vehicle sales have fallen off of last year's pace and could drop even more sharply through the remainder of the year.

PRODUCER PRICE INDEX Friday, Oct. 12, 8:30 a.m. EDT ► Producer prices of finished goods likely increased 0.2% in September, based on the S&P MMS median forecast. In August, prices jumped an unexpected 0.4%. Excluding food and

energy, core prices in September likely rose 0.1%, after declining 0.1% in August. Energy prices should fall as crude-oil prices have dropped nearly 20% since September 1.

CONSUMER SENTIMENT Friday, Oct. 12, 8:30 a.m. EDT ► The University of Michigan preliminary October index on consumer sentiment likely fell to 77, after rising to 81.8 for the final reading in September. The forecast would put the index at its lowest level since July, 1999.



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THE
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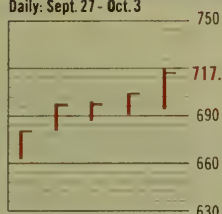
BusinessWeek Fifty

Apr.

Oct.

Daily: Sept. 27 - Oct. 3

Weekly



se 7.3% for the week, along with the resurgent market. Leading the way was software maker tive, which soared 37.3%, and semiconductor maker Xilinx, which rose 23.5%. But the tech com- it alone: Calpine and Dynegy climbed 25.7% and 24.1%, respectively. In fact, only two companies, Communications, lost value.

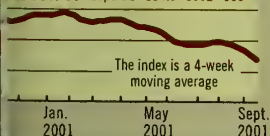
COMPANY PERFORMANCE

any	% change		Rank	Company	% change	
	Week	Since 3/1/01			Week	Since 3/1/01
national	5.7	-14.4	26	Verizon Communications	2.1	13.3
Petroleum	9.0	-24.4	27	Citigroup	10.6	-10.6
	25.7	-39.6	28	Sun Microsystems	6.6	-55.1
	24.1	-14.8	29	Merck	6.8	-15.2
aterials	4.2	-33.1	30	El Paso	19.4	-34.6
Financial	8.7	-57.5	31	Altera	9.5	-29.3
il Petroleum	6.0	0.7	32	Marsh & McLennan	12.5	-0.9
	10.3	-27.9	33	Household International	8.6	-0.3
ee	6.9	-20.9	34	Chevron	8.4	-1.6
	12.0	-36.1	35	SBC Communications	-2.5	1.5
rothers Holdings	11.6	-12.2	36	Mercury Interactive	37.3	-56.5
	-6.4	-72.2	37	AOL Time Warner	6.4	-22.0
	6.9	-76.0	38	Washington Mutual	3.7	14.7
poratories	5.0	11.4	39	General Dynamics	5.2	33.9
on Financial	6.7	-11.0	40	Comcast	8.8	-13.9
chnology	10.1	-47.1	41	Morgan Stanley Dean Witter	14.3	-21.6
	23.5	-35.6	42	Tellabs	0.6	-75.7
Hess	5.9	-13.0	43	Exxon Mobil	10.6	-2.1
gy	8.3	-4.3	44	Scientific-Atlanta	11.6	-59.6
ommunications	11.3	-68.7	45	U.S. Bancorp	6.8	-2.4
ne Financial	10.8	-13.1	46	Paychex	5.3	-21.8
etroleum	6.3	0.2	47	Merrill Lynch	9.1	-30.9
vices	12.5	-10.3	48	Bed Bath & Beyond	12.6	12.7
urces	10.9	-32.3	49	Texas Instruments	6.4	-22.0
health	4.5	10.0	50	Teradyne	6.1	-32.7

Production Index

Change from last week: -0.7%
Change from last year: -7.6%

IAL OUTPUT Sept. 22=164.0 1992=100



i index fell for the seventh consecutive culation of the four-week moving aver- declined to 161.7, from 163.4. After sear- ts, all components but one were lower tos fell the most as producers continue ; sales. Steel, lumber, and rail-freight wn, as were the index's energy compo- wower, crude-oil refining, and coal. Truck e the only category higher for the week. h of the index components is at www.business-week.com.
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Online Resources

BW 50 Track the index and the companies in it all day long. Plus: our exclusive Info Tech 100 index.

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BusinessWeek online

For more investment data and the components of the production index, visit www.businessweek.com.

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This Index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.

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Our condolences

to the families and friends of
all those lost on September 11th,
including those from our own Compaq family.

Our respect and admiration

to the rescue workers for their courage and inspiration.
And to the people of New York City and Washington D.C.
for their perseverance and strength of character.

Our gratitude

to our employees for all their efforts
in helping the Red Cross and the United Way.

We are never stronger than when
we stand together. And we've never
been stronger than we are today.

COMPAQ

AND NOW, THE GOOD NEWS...

Does America now face 10 long years of economic stagnation? Could the next decade for the U.S. be as barren as the last one was for Japan? Might the awful confluence of two rare events—a sharp bursting of a tech-driven bubble and a surprise terrorist attack—generate a liquidity trap that ends America's long-term prosperity? Listen closely to the worried words of a number of economists, Wall Street money managers, and Washington policymakers, and the questions appear to be growing in resonance. We, too, take the argument very seriously, not because it is right—it isn't—but because it highlights the dangers ahead for the U.S. as it battles both recession and terrorism. Washington and Corporate America must choose the right policies if the country is to return to growth and prosperity in the near future.

It is all too easy to dismiss Japan's long stagnation with an arrogant "they blew it, we won't." There are significant parallels between Japan's and America's economic experience. Japan has long suffered from overcapacity and lack of confidence—too much stuff and too little consumer demand for it. This is America's predicament today. Japan has long tried to solve these economic problems with sharply lower interest rates and dramatically higher government spending. This is exactly what the U.S. is doing. Japan had a soaring stock market that made capital cheap and overbuilding easy. Its collapse dealt a huge blow to personal wealth and confidence. All sound familiar? Don't forget that Japan was the high-tech leader in the 1980s. There is enough credibility in the parallels to legitimately make people nervous.

THE U.S. IS NOT JAPAN

But the differences between America and Japan are equally striking and important. The flexibility and transparency of a deregulated, market-driven, entrepreneurial, competitive economy give the U.S. its real strength. Just witness how fast U.S. markets respond to new events. In the '90s, on the upside of the boom, markets channeled capital to new technologies and startup companies. In this steep economic downturn, markets are flushing out overcapacity, winnowing the weak from the strong. They are repricing assets and, in effect, writing down bad debts at an astonishing pace. Vulture funds are moving into distressed companies, and venture capitalists are already looking for the next big thing. Corporations are cutting back, sloughing off units, or going bankrupt. Many are using lower interest rates to restructure their finances, as are many individuals. Consolidation is taking place at warp speed. Creative destruction is alive and well in America (pages 37, 40).

Not so in Japan, where consolidation has proceeded in slow motion for an entire decade of woe. Equity cross-holdings by companies and banks have long hidden real earnings and masked serious corporate losses. Banks have refused to mark loans to market, obscuring the true values of depressed assets. They have little incentive to make new loans regardless of how low the Japanese central bank cuts interest rates. Government

bailouts have kept corporations and banks from going out of business. Political corruption has wasted trillions of taxpayer dollars, running up a gargantuan public debt. All this kept Japan frozen in place.

RECOVERY IN MID-2002

Still, there are troubling signs that the U.S. may be showing some of Japan's symptoms. Corporations increasingly obscure their real earnings with pro forma and other accounting tricks. CEOs are blaming far too many financial problems on the terrorist attacks rather than the economic slowdown or their own blunders. Competitiveness in some sectors is suffering as well. Take telecom, where big, monopolistic Bells have been quick to raise prices on broadband connections to private homes as their upstart competitors have been a victim to consolidation. Government bailouts are growing too. Given what we now know, it may have made more sense to let the airlines operate in bankruptcy rather than hand them, Japanese-style, \$15 billion in cash and loan guarantees, no strings attached. Other industries are now rushing to line up for federal largesse.

These should be resisted. Handouts can weaken confidence and slow the pace of recovery. Washington should take care to keep the markets free and competitive. Corporations, for their part, should resist the temptation to use the terrorist attacks as cover to massage their numbers. Instead, they should clean up their books and give investors more transparent financial information.

There is a decent chance that the U.S. will be getting back on its feet again, perhaps strongly, by the second half of 2002 after emerging through a severe and painful recession over the next nine months. Policy is working, and worries about a liquidity trap are overblown. The Federal Reserve is cutting rates quickly, deeply, and continually. The Bush Administration mailed rebate checks out early in the downturn, and its policy is shaping up to be expansive, but not wildly so. It is proper concern to moderate the next stimulation package so that it doesn't raise long-term rates. With the markets reorienting themselves and corporate consolidation well under way, growth should return.

The key is confidence. It marks the last difference between Japan and the U.S. Japanese consumers long ago lost confidence in their leaders to take the steps necessary to right the economy. Consumers retrenched, cutting back on spending and saving huge sums to protect themselves. This ended growth for 10 years. Consumer confidence is also weak in the U.S., crushed by the twin jolts of recession and terrorism. Confidence in the institutions of government—the President, the Federal Reserve, and the military—to secure the peace and return the economy to prosperity remains extremely low. If Washington can manage the perilous days ahead without damaging the agility of the nation's economy, confidence in growth may well rebound with a strength that surprises

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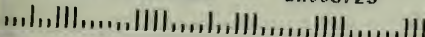
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SPECIAL REPORT

THE FUTURE OF NEW YORK

WILL IT REMAIN THE
PREEMINENT GLOBAL AND
FINANCIAL CAPITAL?

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COVER STORY

THE FUTURE OF NEW YORK

Can the city count on its markets and moxie to bounce back from the devastation?

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BusinessWeek

OCTOBER 22, 2001

Cover Story

96 THE FUTURE OF NEW YORK

In the wake of September 11, the whole country has been moved by New York's heroism, selflessness, and sheer strength. But will a recession and a new, possibly lasting war hasten America's city of dreams into another era of pessimism, crime, and poverty?

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Up Front

EDITED BY SHERIDAN PRASSO

THE TRAVEL BUG

HOW LONG WILL THE FEAR FACTOR LAST?



EMPTY:
Holiday
preview?

CHEAPER FARES MAY BE luring some people back to the skies, but a new poll shows travel will remain depressed for some time. The Travel Business Roundtable findings released on Oct. 9 find 20% of people say they'll discourage friends and relatives from flying during the holidays, and nearly 80% say they believe another terrorist attack is likely. Among busi-

ness travelers who've cut back on flying, a third say they won't be taking as many out-of-town trips for at least six months; two-thirds say they wouldn't travel more even if security were dramatically increased.

The economic hit from fear extends beyond airlines. Car rental counters report significant decreases at airports. The hotel industry, says Loews Hotels CEO Jonathan Tisch, will likely lose \$2 billion this year. "All but critical corporate travel is being delayed, and individuals are canceling or postponing personal travel," he says. Next year should be better, argues Hilton Hotels CEO Stephen Bollenbach: "The American people are not going to live in a hole in the ground. They'll be back." But not soon. *Michael Arndt*

HOME FRONT

REALITY CATCHES UP WITH REAL ESTATE

UNTIL NOW, ONE OF THE remaining pillars of the economy has been the housing market. But that's weakening, too. "Like everything else, this bright spot in the American economy has been eclipsed," says David Lereah, chief economist for the National Association of Realtors.

Indeed, sales of existing homes are down 5% nationwide, says Lereah, who is cutting his existing-home sales forecast to a seasonally adjusted annual rate of 5.2 million. Those sales had hit a new record in August, rising 5.8% to an annual rate of 5.5 million homes. New-home sales, which logged in at an annual rate of \$98,000 in August, are also expected to drop to 790,000 by December.



Still, it's not all gloom and doom. This will still be the industry's second-best year ever. And economists say mortgage rates, at their lowest level in two years, should help prevent the market from toppling. Huge backlogs at homebuilders will help, too.

Industry experts hope for a rebound by next spring. But, cautions NAHB chief economist David Seiders, if there are more terrorist attacks or the economy continues to wane, "all bets are off."

Stephanie Anderson Forest

TALK SHOW For an airline, "the government is precisely the kind of shareholder you want.... What are they going to do, come down to a board meeting and demand management changes?"

—Austan Goolsbee, a University of Chicago economist, objecting to the U.S. government's plan to take equity stakes in the airlines



RATIONS:
Make 'em
gourmet

GOOD TASTE

RESCUING WORKERS' PALATES

AS NEW YORKERS STRUGGLE TO GET BACK TO NORMAL AFTER the devastating World Trade Center attacks (page 96), it is a curious way reassuring to realize that one attribute of residents has remained undiminished: their fussiness about food.

That quickly became apparent to the American Red Cross when, on September 11, it moved in to set up its usual mobile kitchen operations on the periphery of the disaster area to feed rescue workers and victims. Alas, as Robert Bender Jr., head of the Greater New York chapter, recalls, canned ravioli and other bulk-prep fare standard at disaster sites "didn't work here at all." Too many workers simply turned up their noses.

Into the breach stepped New York's top-rated chefs—from Tribeca Grill, Daniel, Danube, Tavern on the Green, and Harlem institution Sylvia's, among others—with top-notch cuisine shuttled down from their kitchens, or whipped up by the chefs themselves on a nearby docked cruise ship. Even after the restaurants turned back to serving regular customers, the Red Cross didn't go back to the usual canteen style fare. It switched instead to caterers.

With New York restaurants reeling from a dearth of visitors, chief tourism promoter Cristyne L. Nicholas would like to think the donations served as a sampling opportunity for hitherto untapped audience for fine dining: "I hope when this is over, [the rescue workers] will be going to Le Cirque and Jean-Georges." *Gerry Khernouk*

THE LIST BEST PLACES TO BE UNEMPLOYED

Joblessness is at a nine-year high and President Bush is proposing federal help. Even the highest weekly unemployment benefits are less than half of workers' previous pay



STATE	MAXIMUM BENEFIT*	% OF INCOME REPLACED FOR AVERAGE WORKER
MASSACHUSETTS	\$527	36%
WASHINGTON	441	40
PENNSYLVANIA	438	40
RHODE ISLAND	437	41
NEW JERSEY	429	35
CONNECTICUT	427	27
MINNESOTA	427	43
NEW YORK	405	29
ILLINOIS	392	35
OREGON	376	38

*for a worker with two children and an employed spouse
Data: Economic Policy Institute



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Up Front

SEPTEMBER 11

NO SILVER LINING FOR TECH SALES



THE BUSINESS OF REBUILDING after the September 11 attacks is not going to pull tech companies out of their financial doldrums. True, some companies have gotten large computer equipment orders. Dell Computer, for example, is currently shipping 25,000 new PCs to Morgan Stanley Dean Witter, which had to relocate more than 20 floors of offices lost in the World Trade Center. And some analysts expect Cisco Systems to receive nearly \$60 million in replacement orders in the coming months. Cisco and Dell have stuck by previous estimates for current-quarter sales.

But replacements will do little to offset the bleak tech

picture, which was only made worse by the attacks. Since September 11, some analysts have lopped \$350 million off projections for Cisco's 2002 profits, despite the new orders.

Others are faring no better. Estimates for 2002 sales at Extreme Networks, which sells replacement networking gear to the Pentagon, have been shaved by \$100 million—that's 18%—since the attack. "Rebuilding will not offset the slowing economy," says Merrill Lynch analyst Sam Wilson.

Nor do software companies expect a jump. Advent Software, for example, had more than 25 customers in the Twin Towers. But any replacement software is covered under existing licenses. "Let's get real about this," says Advent's Chief Financial Officer Irv Lichtenwald. "Emotionally, much of the world is reassessing their priorities." And for now at least, those priorities don't include a tech buying spree.

Ben Elgin and
Jim Kerstetter

THE BIG PICTURE



BIG BROTHER, WHERE ART THOU?

Americans believe that law enforcement agencies should be granted more power to better combat terrorism.

PERCENTAGE THAT SUPPORTS

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Closer monitoring of bank and credit-card transactions

A national I.D. system

Monitoring of chat rooms

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THE CRISIS IS PROMPTING people to reach out to religion in search of answers. And a group of Carmelite nuns is reaching back—online. The 15 sisters of the Carmelites of Indianapolis run a Web site, www.praythenews.com, aimed at connecting with the public. On it, they offer spiritual reflections on current events, such as the question President Bush asked in his address to the nation, "Why do they hate us?" Sister Therese posts the response: "We can no longer meddle in the politics of other countries with the intention of serving our own self-interest. We are indeed one body." Traffic is up 34% since September 11, to 19,400 visitors a month.

The nuns, most of them graying and past middle age, started online outreach in March to show that a life of prayer does not mean a life of isolation. They wanted to attract young women to the order and challenge the misconception that nuns are detached from the world.

They've assembled a board of advisers, hired an agency, and tallied 24 queries about joining, compared with 10 last year.

The "light a candle" page of the site, where visitors submit prayers, is receiving about 200 a day.

CARMELITES:
Reaching out

up threefold from before the crisis. "Most of the prayers we're getting are really for peace," says Sister Therese, including one submitted to Allah. "We do get anything like, 'Go get 'em.'" Kimberly Weir

A SAD-BUT-TRUE COMMENT ON THE PLIGHT OF NORTEL MAKING THE ROUNDS ON THE INTERNET

October 2000
\$1,000 invested in 15 shares of Nortel stock

\$63.25

October 2001

Collect \$81

from sale of Nortel

October 2000

\$1,000 "invested" in 30-cases of Miller High Life

October 2001

Collect \$103.50 from deposit on cans

October 2001

Collect \$103.50 from deposit on cans

October 2001

Collect \$103.50 from deposit on cans

October 2001

Collect \$103.50 from deposit on cans

October 2001

Collect \$103.50 from deposit on cans

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INTEL CORRECTS OUR ARITHMETIC

Your article on Intel Corp. picked on us unremittingly ("Intel," Cover Story, Oct. 15). This saga of a sea of screwups punctuated with bad strategies made me wonder: Can we be this bad, or is *BusinessWeek* this biased?

Then I ran across a Freudian slip: After saying that industry shipments are expected to decline 34% from 2000 to 2001, you suggest Intel revenues will drop 52%, from \$33.7 billion to \$25.5 billion. Assuming your 2001 number is right, by my calculations these revenue numbers correspond to a 24% drop, not 52%. So I again wonder: Is an error this gross a hint of bias—or merely an indication of the quality of writing and editing? We will work hard to do better. May I suggest you do likewise?

Andrew S. Grove
Chairman
Intel Corp.
Santa Clara, Calif.

Editor's note: We erred. The correct number for Intel's expected revenue decline is 24%.

GOVERNMENT SPENDING DOESN'T HURT THE PRIVATE SECTOR



"Rethinking the economy" (Special Report, Oct. 1) states that increased spending by the government will mean smaller surpluses, higher long-term interest rates, and less private investment. No causal relationship has been proved between government spending

and surpluses, private investment, and interest rates. To wit, the 1990s saw increased government spending (at increasing rates)—and, at the same time, bigger surpluses, lower interest rates and higher private investment.

Sam Katzman
Ridgewood, N.Y.

SEPTEMBER 11: WHAT'S BEHIND THE HATRED

While the Afghans are bent on treating to the Stone Age ("The roots of resentment," Special Report, Oct. 1), America is garnering hate for our foreign policies. We will always be criticized for being self-serving because we are the mightiest nation in the world.

American policy is more than selfishness. Americans always display sympathy and give support to those less fortunate. America should continue its policy to keep the combatants separated and quell those who seek to wreak havoc on the world. If anyone has selfish interests, it's the terrorists and dictators of the world.

J.P. Stak
South Windsor, Conn.

The U.S. is the only legitimate economic and military superpower. Its culture, from movies to blue jeans, has influenced even the poorest of nations many years. Nobody gives more humanitarian aid than the government and people of the U.S. (the biggest provider of food to Afghanistan). Despite this, the term "ugly American" is becoming more popular. By nature, however, Americans genuinely want to help others.

I am not advocating an isolationist stance, but many times I feel that the U.S. needs to cooperate better with allies in international affairs and stay out of individual countries' domestic issues.

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Readers Report

ORRECTIONS & CLARIFICATIONS

ving to problems with Standard & Poor's
tual-fund database, some tables in "The
rtual may not be over" (Finance, Oct. 8)
ve incorrect data for merged Firststar
nds. Third-quarter returns through Sept.
were: First American Equity Index Fund,
7.80%; First American Balanced Fund,
1.82%; First American Fixed Income Fund,
3.86%; First American Tax Free Fund,
2.27%; and First American Small Cap In-
x Fund, -18.83%.

"The suddenly sexy... government bond"
nance, Oct. 8), the correct name of the T.
we Price fund on "The bond fund leaders"
ble is T. Rowe Price International Bond
nd.

chart in "The new Netrepreneurs" (e.biz,
t. 1) incorrectly reproduced data from
nture Economics about venture-capital
nding of Internet-related startups. Of the
131 companies that received funding in
e second quarter of 2000, 51.6% were in
e e-commerce and content category, 23%
re in Internet software and tools, 13.8%
re in communications and infrastructure,
5% were in Internet services, 2.6% were in
ernet-related hardware, and 2.4% were in
er businesses.

Of the 645 companies that received
nding in the second quarter of 2001,
4.4% were in e-commerce and content,
6.6% were in Internet software and tools,
7.7% were in communications and infra-
structure, 8.5% were in Internet services,
5% were in Internet-related hardware,
d 2.2% were in other businesses.

ess the whole world gets involved.
Robert Cataldo
Houston

Having worked many years in Saudi
bia, I feel we could do a lot to cre-
a coalition against bin Laden, but
don't need to apologize for America
the stuff "for which it stands."

George Swan
Henderson, Nev.

You say that Islamic institutions have
pped in to fill the gaps created by a
akdown in social services, and thus
ople are switching loyalties to an Is-
ic belief system." That's what hap-
s when "faith-based" services take
place of those any decent govern-
ment ought to supply. Clearly, there are
ny issues to which we must respond
erently, but the World Trade Cen-
assault is primarily a crime. If we
rate their regimes, we are blamed

for them; if we don't, that's interfer-
ence. No misplaced guilt trips, please.

John E. Ullmann
Hempstead, N. Y.

STEER HIJACKED PLANES FROM THE CONTROL TOWER

There is another way to stop hijack-
ings: "hands-off landings," in which the
plane is under ground control ("Keeping
the barbarians away from the gate," Spe-
cial Report, Sept. 24). Control of all the
vital parts of the plane—fuel adjust-
ments, ailerons, rudder, flaps, etc.—should
be available to the tower. If a plane were
hijacked, control would immediately pass
to ground control, and could not be over-
ridden inside the aircraft. If such a sys-
tem had been in effect on September 11,
disaster could not have occurred.

Judson H. Spencer
New York

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PRESERVING THE WORLD'S GREAT CITIES
The Destruction and Renewal of the Historic Metropolis
By Anthony M. Tung
Clarkson Potter • 469pp • \$40

THE FRAGILE CHARM OF CITIES

New Yorkers know as well as anyone that great cities are works in progress, buffeted by avarice, ideology, and politics. Now, New York has seen firsthand how acts of terrorism can tear at the urban fabric. But every great city rests, in part, on the sundered stones, walls, and foundations of its own past. Those foundations are resilient, like the inhabitants themselves. Brought to their knees, cities rise again, building on what came before.

As New Yorkers set about designing and building whatever will stand in the place of the Twin Towers, they would do well to consult Anthony M. Tung's masterly *Preserving the World's Great Cities*. A former landmarks-preservation commissioner in New York, Tung in 1995 began visiting 22 cities, from Amsterdam to Vienna, from Cairo to Kyoto. This far-reaching book, the result of those travels, weaves well-told tales of urban destruction and renewal, using preservation and planning as the prism through which history is viewed. For example, Tung examines Warsaw's painstaking postwar restoration of its 17th century Old Town, itself a reconstruction of an older neighborhood destroyed by fire. He looks at how religious conflict has devastated Jerusalem and how Berlin wrestles with its dark past as it has recovered from World War II—and three decades of being split by the Wall. In each chapter, he evaluates varying approaches to preservation, seeking solutions that might stem the destruction and loss of historical treasure that go hand in hand with development.

The earliest attempts at preservation, we learn, date from the seventh century B.C. in Mesopotamia. There, anyone who dared to despoil the appearance of the Royal Road of Nineveh was hanged from the roof of his own house. By the fifth century A.D., pun-

ishments had eased somewhat: In Rome, Emperor Majorian decreed that workmen found stripping marble from imperial monuments have their hands cut off. Those Draconian measures notwithstanding, neither Majorian nor his successors could halt Rome's physical deterioration. By the 11th century, uncleared debris and garbage had raised the level of Rome's streets by as much as 20 feet. The once-proud city of 1 million inhabitants became a swampy village of 30,000. The engineering and artistry that had raised aqueducts, fountains, and temples adorned with intricate sculptures went into suspended animation.

Then, Rome rose again. In 1420, the papacy returned to the erstwhile imperial capital. And as the Renaissance progressed, Romans rebuilt their city—creating much of the metropolis we know today out of the original marble from the long-destroyed palaces of the Roman elite. "The fact that a significant part of the imperial legacy of Rome was not passed down to us is largely a matter of choice," Tung writes.

In the modern era, Rome and other cities around the world face similar choices. Building in city centers requires destroying something first. And these days, what goes in is often constructed in an international style that ignores the traditions, craftsmanship, and materials that make a city distinctive. In Singapore, for example, the vernacular architecture that blended Chinese, Malaysian, and British colonial traditions has been replaced by steel-and-glass towers that look much like those in London and New York. While Tung isn't against modernism, he points out, rightly, that historic neighborhoods and the buildings that constitute them are "a

finite resource from a closed period of human evolution." His emphasis is maintaining the fabric and texture of neighborhoods: Isolated from the environment in which they were constructed, solitary buildings provide little insight into history.

Some cities have done a better job preserving their traditional architecture. In Amsterdam, a 17th-century core of low-rise row houses nestles along the city's canals. The historic area was saved by a city commission that in 1950s provided public funds to restore endangered buildings in run-down neighborhoods. In Paris, a 1974 land-use law designated nearly 60% of the city as a historic zone, limiting the height of structures to traditional norms.

Preserving the World's Great Cities not just for policy wonks. Yes, it tails the roles of planning and preservation in the development of urban areas, but in each chapter Tung presents lively political and architectural history of the cities he studies. And while disciples of modernism might find his perspective somewhat stiff, he makes clear that he doesn't oppose modern architecture. He simply believes the impulse to destroy and build anew should outweigh the often-less-patible path of conservation.

Tung, writing before the attacks of September 11, describes the battles over rights in New York and the ever-present role of politics in its development. While New York hasn't always done the best job of preserving its past—the molition of the old Pennsylvania Station is just the most notorious example—the city consistently manages to reinvent itself and move on. His presence is clearly for preservation, especially in neighborhoods that maintain their original texture, such as Greenwich Village. But he also notes the tearing down and building up again as a vital part of New York's tradition. While the cause of the current devastation is utterly unlike other catalysts of change, the result will surely be the same: New York will rebuild.

BY DAVID RO
Rocks has written extensively
planning and architect



BAD POLICY, WRITES TUNG, CAN UNRAVEL THE TEXTURE OF HISTORIC NEIGHBORHOODS

STEPHEN H. WILDSTROM

h&y@businessweek.com

WINDOWS XP: IT'S A KEEPER



any of the
st changes
e invisible.
? simply
orks better
an Windows
, 98, or Me

Marketing is about sizzle, so as Microsoft moves toward the official Oct. 25 launch of Windows XP, expect to hear a lot about its colorful new looks, the rich use of graphics, and a number of new features. The latest bells and whistles range from the useful to the annoying, with some of the best easing the handling of pictures, video, and music. But none of this has much to do with why you should consider moving to XP.

The changes in XP that really matter are not obvious and are, in many cases, invisible. XP is important because, simply, it works a lot better than Windows 95, 98, or Me. Since Microsoft released Windows NT 4.0 in 1996, and especially since Windows 2000 came out two years ago, consumers have been second-class citizens. True, NT and, to a lesser extent, 2000 require a technician to install and configure. These business-oriented operating systems are fussy about software

and even pickier about what hardware you can use. But they work without the crashes and mysterious glitches that have always plagued consumer versions of Windows. Microsoft has been struggling for several years to retain the stability of NT while making it easier to use and getting it to work with a much broader range of hardware and software, including arcade-style games.

SPLASHY COLORS. Windows XP is the result, and on the whole, it's a success. XP comes in two flavors: Home, a \$99 upgrade from Windows 98 or Me, and Professional, a \$199 upgrade from Windows 98, Me, NT, or 2000. Pro will probably also fetch a \$100 premium above the cost of a new computer.

The two versions are essentially the same. The Home edition lacks a few features, including file encryption, remote access, and integration with Windows 2000 Server. These are important to big enterprises but of little interest to consumers. The Home edition includes most of the security features of Pro, including support for multiple users and safe file-sharing on networks. (I'll write about getting the most out of the security features in a future column.) There's no reason for home users to spend the extra money unless they have been running NT or 2000, which can only be upgraded to the pricier edition.

When you fire up Windows XP, you'll notice that the screen looks different from the familiar design, which has changed little since Windows

95. The most striking thing about the new look is the bold—in my opinion, garish—use of primary colors. Fortunately, you can easily switch back to the calmer blues and grays of classic Windows. But whichever look you choose, you'll get the benefit of important usability improvements, some of which first appeared in Windows Me and 2000 and some of which are new to XP.

The Start menu has undergone drastic revision. It uses new, more detailed icons to give you graphic clues about the contents of its seven logically organized panes. In the upper left-hand corner are icons

for your Web browser and e-mail program. When you first set up XP, these are Internet Explorer and Outlook Express. But if you install Netscape and make that your

THE START MENU

Microsoft has taken advantage of the improved graphics capabilities of today's computers and monitors with brighter colors and sharper icons. The Start menu also features a more logical organization.

The screenshot shows the Windows XP Start menu for user 'steve_wildstrom'. The menu is organized into several panes. On the left, there are links to 'Your Internet browser and e-mail, probably the most-used software applications for most people. You can change Microsoft's programs to use what you prefer.' and 'Your most frequently used applications appear here automatically.' Below these are links to 'As in older Windows programs, clicking here provides a menu of all your applications.' and 'INSTALLING XP ON YOUR COMPUTER worth the trouble? Check the details of upgrading at Technology & You at www.businessweek.com/technology/'. The main menu area lists applications like Internet Explorer, Microsoft Outlook, MSN Explorer, Windows Media Player, Windows Movie Maker, Tour Windows XP, Files and Settings Transfer Wizard, and PDAsync Debug Log. On the right, there are links to 'My Documents', 'My Recent Documents', 'My Pictures', 'My Music', 'My Computer', 'My Network Places', 'Control Panel', 'Printers and Faxes', 'Help and Support', 'Search', and 'Run...'. At the bottom, there are links to 'Log Off' and 'Shut Down'.

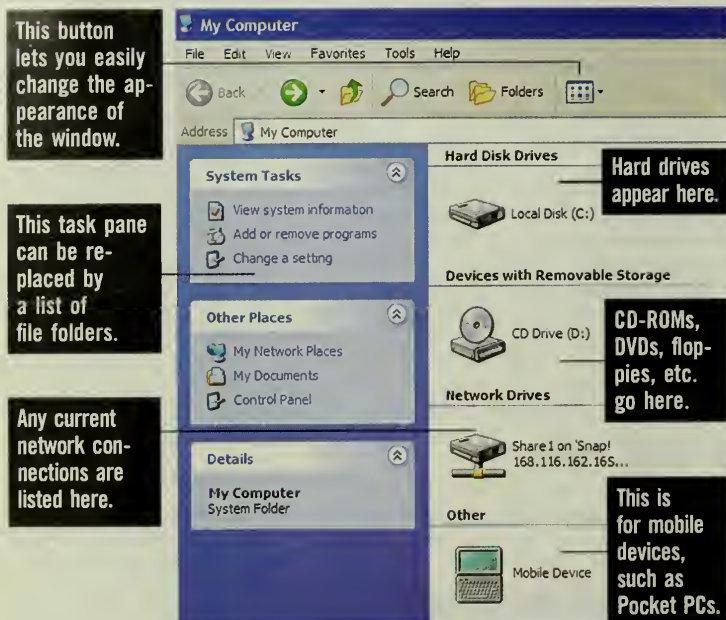
More choices in file locations. The differentiation of photo and music files is welcome.

You still have to click, counterintuitively, on Start to get the Shut Down controls. But at least they are clearer.

default, the icons automatically change. Just below are a list of your most frequently used applications. As part of the relentless self-promotion that pervades XP, these are set initially to a variety of Microsoft offerings, such as Media Player and Movie Maker. But as you start using your own applications, their icons appear on the list. The All Programs button on the bottom opens a program listing similar to that in previous Windows versions.

THE MY COMPUTER SCREEN

The new version cleans up the jumble of icons providing links to important functions or locations.



The dark side of Windows XP: Not-so-subtle nudges to get the user to use services favored by Microsoft

Panes on the right give you access to key file folders such as My Documents, a variety of system management panes, a help and search pane, and shutdown and log-off controls. (Yes, shutdown is still on the Start menu.) Another folder is My Network Places, which lists storage either on a LAN or, as is becoming increasingly important, on the Web. For example, Microsoft is partnering with Xdrive Technology to offer 75 megabytes of Web storage for \$4.95 a month.

Where designers use the new icon approach to particular advantage is the My Computer screen. The older version was a jumble of icons for disk drives, CD-ROMs, maybe a network drive or two, and, for no apparent reason, an icon for the Control Panels. The new My Computer is, like many XP windows, multipaned. The main section groups storage devices by type: hard drives, removable

media, and network connections. A strip on the left offers system tasks, such as adding or removing programs, and a list of other folders such as My Documents. With the click of a button, you can exchange that strip for a Windows Explorer-style list of all of the folders on your computer.

Another important change is that XP understands that while pictures and music may just look different to a computer, people regard them as fundamentally different from, say, Word documents. XP handles them more intelligently. So when you open a folder containing photos, you see thumbnail versions of the pictures, rather than icons, and the window's task menu changes to include picture tasks, such as printing or showing the images on the screen as a slide show.

TOO PUSHY. Unfortunately, this special handling of media leads to the dark side of Windows XP. Microsoft sees Windows as a way to steer business to commercial services provided by the company and its partners who, in effect, pay Microsoft to rent space on your desktop. So when you choose the "Order prints online" task in a photo folder, Windows steers your business to Microsoft partners Shutterfly and Fujifilm. Click "Shop for music online" in a music folder, and you're off to Microsoft's WindowsMedia.com. Whether this is illegal leveraging of Microsoft's desktop monopoly is an argument I'll leave to the lawyers, but I don't like it.

Microsoft is equally aggressive in using XP to promote its nascent .NET services. Starting during setup and from time to time thereafter, a pop-up window asks you to sign up for Microsoft Passport, which lets you use a single log-in and password for a variety of Web sites. You can ignore the request, and it will go away, but it comes again, I resent the badgering. (I'll offer advice on getting Microsoft and other vendors out of your face in an upcoming column.) For now, registering a Passport through Windows XP doesn't cost much. The main effect seems to be automatic notification when mail arrives in your Hotmail inbox. But Microsoft has plans for a slew of services based on Passport.

These, however, are fairly minor complaints about what is, on the whole, a big improvement in usability. That said, should you rush out and spend \$100 or so to upgrade your computer? For a detailed discussion of the promise and pitfalls of upgrading, see Technology & You online. In general, upgrading from Windows 95 is out of the question and Windows 98 is problematic. An upgrade from Windows Me is fairly straightforward and mostly likely to be worth the trouble, since Me is awful. The upgrade from Windows 2000 is generally easy, but the payoff is not that great, since 2000 is already very good.

If you run Windows, sooner or later you will want XP. Maybe you don't need it badly enough to buy a new PC immediately or to plunk down \$100 and try what could be a difficult upgrade. But this is the first version of Windows since Windows 3.11 that makes a real difference for the average computer owner. It's definitely worth having.



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that this long-distance argument had been
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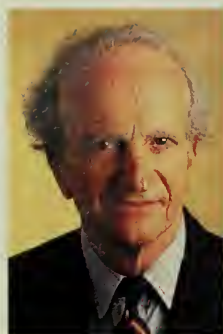
CONNECTORS & SWITCHES

SATELLITE SENSORS

AEROSPACE CONTROLS

BY GARY S. BECKER

DON'T BE SURPRISED IF THE RECOVERY IS RAPID



REBIRTH:
While the comparison isn't perfect, Kobe's rebound from the 1995 quake offers insight in the wake of the terrorist attacks

The tragic loss of life and property from the September 11 terrorist attack has taken an enormous psychological toll, but will it severely damage the American and world economies? Although short-run economic damage is already obvious, the chances are excellent of long-term recovery to prior growth rates.

The possible pace of economic recovery from the attack can be gleaned from comparisons with major natural disasters, where recovery has generally been quick. John Stuart Mill, the great economist and philosopher, remarked in the 19th century: "What has so often excited wonder, the great rapidity with which countries recover from a state of devastation, the disappearance in a short time, of all traces of mischief done by earthquakes, floods, hurricanes, and the ravages of war." He recognized that knowledge and skills are the prime engine of economic growth and prosperity. Fortunately, America retains its vast supply of both.

The enormous earthquake that hit Kobe, Japan, in 1995 is an excellent illustration of Mill's conclusion because it was the most severe quake to strike a modern city. It destroyed more than 100,000 buildings, badly damaged many others, and left hundreds of thousands homeless. Over 6,000 persons lost their lives—about the same number as died on September 11, but that is a much larger fraction of the Japanese population. Despite predictions that Kobe's recovery would take a decade or longer, economist George Horwich of Purdue University has shown that the city had almost fully recovered after a little over a year. Most shops reopened rather quickly, and investments boomed.

The economic loss from September 11 is much smaller relative to the size of the U.S. economy than the damage from this earthquake. But uncertainty about future terrorism may make the economic recovery from this attack much slower and different from Kobe and other disaster areas. This is surely possible, although uncertainty is pervasive after major earthquakes and other disasters. For example, many Californians feared that the "big one" would come soon after a severe earthquake in 1989. Yet before long, the California economy fully recovered.

FORCE OF WILL. Moreover, terrorism, like other major crimes, can be reduced by appropriate public and private actions, whereas most natural disasters are beyond human control. The U.S. and Europe have already started to take various steps toward improved security that will add to confidence about safety and hasten the econo-

my's return. The cost of a major increase in protection against terrorism is not trivial, but probably would not damage long-term economic prospects. For example, an additional 50,000 trained guards assigned to airports, flights, nuclear and water plants, and other sensitive facilities would cost less than \$3 billion annually.

Nevertheless, the U.S. economy, already in downturn prior to the September 11 attack, may have been pushed into recession. Confidence has apparently oozed out of consumers and investors. Measures of consumer confidence in the economy have fallen more sharply than at any time since the oil embargo in the 1970s and Iraq's invasion of Kuwait at the beginning of the 1990s. Pessimism and uncertainty about the future are reflected in the large drop in stock prices during the first week after markets reopened, although the markets recovered much of their losses during the following two weeks.

Airlines, hotels, and other industries that depend on travel have been particularly hard hit. Airline stocks declined by more than 40% between the close of Sept. 10 and that of Sept. 17, the first day of trading after the attack. In comparison, prices of airline stocks were down less than 3% two days after a bomb destroyed the Pan Am flight from Lockerbie, Scotland, in 1988, and by under 7% after a TWA crash in 1979 that was erroneously blamed on a missile.

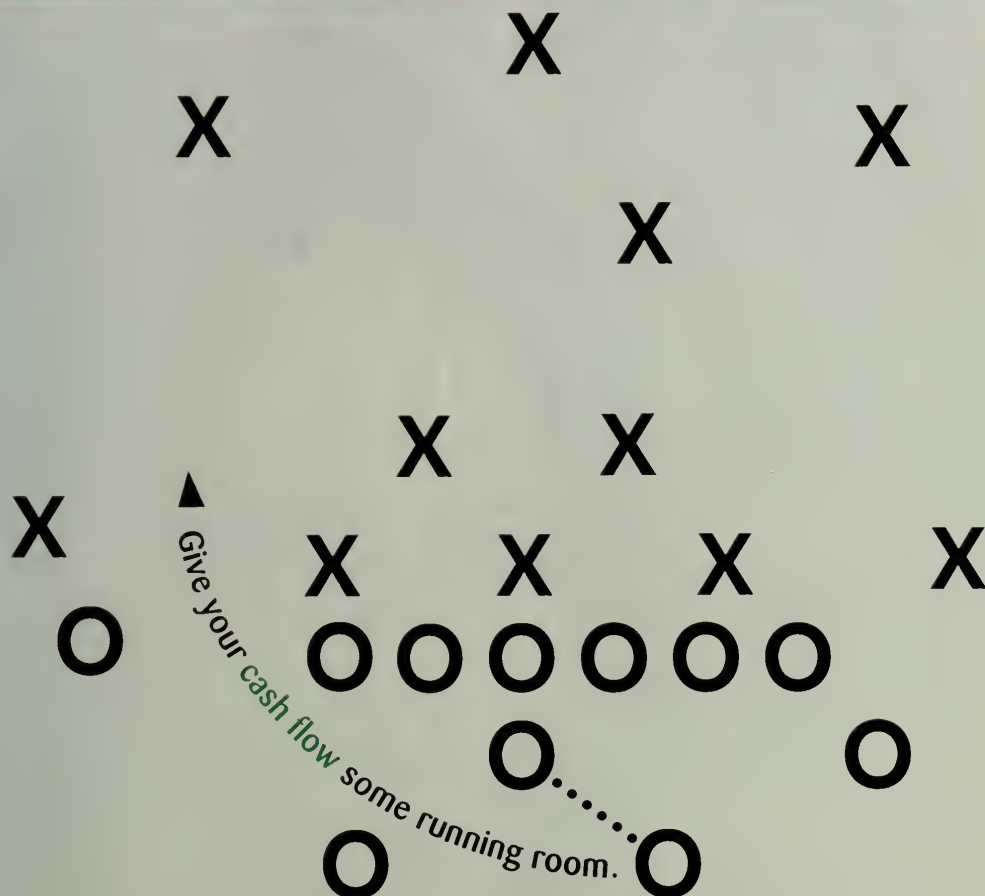
WAR DIVIDEND? Seat occupancy rates on flights within, and to and from, the U.S. plummeted during the first week after air travel resumed. Typically, airline traffic returns to normal within a few months after a major plane crash. Clearly it will take longer after this devastating attack, but confidence about air safety has been growing and traffic is steadily climbing toward pre-attack levels. The placing of federal marshals on many planes and additional security measures should help boost travel further.

The effect of the attacks on the overall economy will also be mitigated because the shifting priorities toward greater safety from terrorism will help industries such as defense, intelligence, videoconferencing, and surveillance.

Moreover, many industries will benefit from the lower oil prices that should continue for a while, assuming no large-scale destruction of production capacity in the Middle East.

Obviously, psychological and other scars from the terrible events on September 11 will remain. But if future terrorism can be kept in check, the long-term development of the U.S. and world economies should not be permanently retarded.

Gary S. Becker, the 1992 Nobel laureate, teaches at the University of Chicago and is a member of the Hoover Institution.



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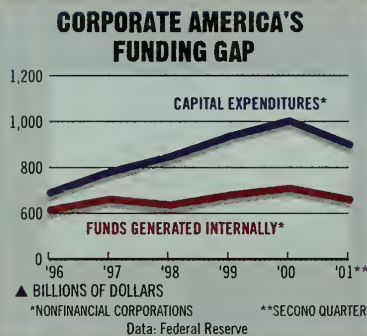
BY MICHAEL J. MANDEL

CAPITAL SPENDING: FURTHER CUTS?

Corporate finances are stretched

What will happen with business investment in the wake of the September 11 attacks and the initial stages of the U.S. retaliation in Afghanistan? One unpredictable factor is business confidence, which will rise or fall on the success of the military campaign.

Whatever happens to confidence in



the short run, though, Corporate America is starting from a financially vulnerable position, according to economists at J.P. Morgan Chase & Co. And that makes capital investment especially liable to additional cuts.

The reason for this vulnerability is that corporate spending on equipment and buildings still far exceeds the amount of cash that companies are generating internally (chart). The latest figures show that this difference between capital spending and internal funds—also known as the “financing gap”—was running at an annual rate of \$251 billion in the second quarter of 2001. That's down from the peak financing gap of \$329 billion in the fourth quarter of 2000, but it's still quite large by normal standards. To put it another way, companies are having to raise 28% of their investment funds from external sources. That's compared with the historical norm of 10% to 20%, according to the J.P. Morgan Chase economists.

A big financing gap means that companies have to borrow heavily to support investment at a time when the economy is in turmoil. That's not what most chief executives want to do. Instead they want to reduce dependence on debt during uncertain times. “Capital spending is still unusually high relative

to cash flow,” notes Calvin Schnure, a senior economist at J.P. Morgan Chase, “With any recovery being pushed out a quarter or two, firms will want to postpone or cancel a lot of outlays.”

There are mitigating factors, observes Schnure. Balance sheets are in relatively good shape. Companies have a lot of liquid assets, and they took advantage of low interest rates in recent years to re-finance their long-term debt. And cash flow has stabilized because of dividend cuts and cost-cutting.

Nevertheless, excessive dependence on the credit markets seems less and less appealing as the world seems more dangerous and the economy turns sluggish. Capital investment may have quite a bit more to fall before hitting bottom.

HEALTH CARE IS LOOKING HEALTHY

It's one of the few sectors hiring

The September employment report gave few reasons for optimism. Even though most of the data does not reflect the effects of the September 11 attacks, the report still showed a 199,000-job decline, the largest in more than 10 years.

Yet some industries were still adding workers. In particular, the health-care sector, outside of government-run hospitals, grew by 29,000 jobs in September, equal to its average growth over the previous three months. In fact, over the last year, health care has generated 283,000 jobs, making it the second-biggest source of new jobs. The only industry with a bigger gain over that period was education, which added 338,000 workers.

Indeed, employment outside of health and education shrank by more than 500,000 jobs over the last year. Thus, even before the attacks, U.S. growth was being driven by health and education. And that may persist even after the U.S. recovers from this downturn.

HURTING IN LOCKSTEP

Globalization means shared pain

In the past half-century, there has never been a global recession. Even when the U.S. was deep in the mire, the world economy as a whole kept on growing. In 1991, for example, the U.S. economy

shrank by 0.5%, but the global economy expanded by 2.7%. In 1982, the U.S. ported negative growth of 2%, while rest of the world grew by 2.6%. Expansion in one part of the world more than made up for contraction elsewhere.

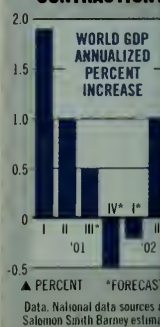
No longer, says Giles Keating, chief economist at Credit Suisse First Boston in London. He and an increasing number of other forecasters predict that the world will plunge into its first global recession since World War II this quarter and next. And for 2002 as a whole, global growth will be lucky to hit 0.1%, the lowest level since World War II.

That's in part the result of globalization, which means economies around the world move more in tandem than they used to. International trade now accounts for almost 20% of global gross domestic product, up from just 10% a decade ago. So manufacturers in one region are hurt more than they used to be by slowdowns elsewhere. It's just exporters that are affected. Markets for many products are now completely international, with prices determined globally rather than locally. “That means domestic-oriented companies in one region feel the full blast of falling demand in another,” says Richard Reid, chief equity economist at Schroder Salomon Smith Barney in London. “Their profits suffer, investment falls, and confidence falters.” Meanwhile, the financial markets are more interlinked and liquid than they were. The capital that kept the emerging markets growing through past U.S. recessions nowadays can yanked out at the first sign of trouble.

To make matters worse, Japan's troubled economy cannot provide the world with an engine as the U.S. stalls. The Asian Tigers, which hardly ever registered recessions, are now heavily dependent on exports to the U.S. and Japan for their vitality. And forget Europe: Economists say its structural problems mean that it can't buck the global trend. Those economies that are still growing—China, for instance—aren't big enough to act as global locomotives. “It's a gloomy picture,” says Keating. “The hope is that global response by policymakers can get things moving again.”

By David Fairclark

WORLDWIDE CONTRACTION?



JAMES C. COOPER & KATHLEEN MADIGAN

WHY WASHINGTON CAN CONTAIN THIS RECESSION

tax and rate cuts are helping households—and more aid is on the way

U.S. ECONOMY

Bad policy put the "Great" in the Great Depression. Protectionism, Hooverism, and a central bank that sat on its hands while markets seized up and banks failed aggravated an already grim situation. Government officials didn't understand how policy would affect the economy. Thankfully, the U.S. has learned from those and other less spectacular policy mistakes. That's why, barring any further shock, this recession should be mild. Because of the sound policy decisions of the past decade, the U.S. now has an unprecedented reserve of policy resources to draw on. As a result, Washington embarked on the most rapid and aggressive response to economic weakness in modern times.

A BOOM IN HOME REFINANCING



Source: Mortgage Bankers Association of America

With weak labor markets and shaky confidence, and headwinds, such as stock market uncertainty. Already, \$38 billion in tax rebates are lifting savings, and debt loads are decreasing, especially through mortgage refinancings (chart). Households will get more help from brand-new tax cuts and spending programs that could total up to \$70 billion, on top of some \$45 billion in immediate post-September 11 stimulus and next year's \$30 billion in tax-law changes. Moreover, the full boost of Fed rate cuts is yet to be felt, and households are getting a windfall from cheap energy. The fall in gasoline prices, from \$1.70 per gallon in May to \$1.42 in early October, suggests a savings of \$25 billion (at an annual rate). Consumer finances are the key to the outlook because the degree to which households rein in their spending will determine the severity of this recession.

KEEP IN MIND THAT the current situation is much different from the 1990-91 recession. Back then, fiscal policy was hamstrung by the prospect of \$300 billion deficits as far as the eye could see. It wasn't until after

the downturn that Washington eliminated the federal budget deficit that was crimping private investment and elevating long-term interest rates. Those efforts produced more investment and high economic growth that boosted tax revenues.

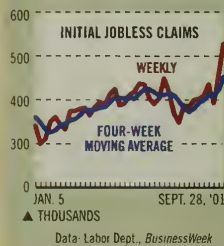
Of equal importance are the preemptive moves of the late 1990s to contain inflation, which have given the Federal Reserve maximum leeway to err on the side of accommodating growth with minimum concern about future price pressures. Inflation-fighting efforts also went beyond monetary policy. Less regulation of private industry and freer trade encouraged competition, cost-cutting, and innovation. Together, low inflation and a budget surplus give Washington great freedom to fight economic weakness without mortgaging the future.

It's not only the flexibility of policy, however, that will keep this recession contained. It's also the fortuitous timing. Large packages of stimulus from the Fed and the White House were already in place prior to the terrorist attacks. The central bank started cutting rates back on Jan. 3 and had trimmed the federal funds rate by three percentage points before September. The tax rebate plan was approved by Congress before Memorial Day, and the first checks were sent out in late July. The timing of these moves means that policy was already helping the economy to stabilize before the attacks on New York and Washington.

NOWHERE IS THAT HELPING HAND more evident than in the consumer sector—and that stimulus should offset some of the burdens weighing on shoppers. The uncertainty of war has rattled confidence and postponed some buying plans. Households are grappling with this year's plunge in the stock market, which has caused some \$3.6 trillion in wealth to evaporate since January. These two factors will be key determinants of future consumer spending, but their influence pales when compared with the labor markets. Consumer spending is affected most by the job markets (chart).

That's why the September employment report was so ominous. Nonfarm payrolls plunged by 199,000 last month, and the jobless rate remained at a four-year

JOBLESS CLAIMS ARE SOARING



Data: Labor Dept., BusinessWeek

high of 4.9%. The Labor Dept. said it conducted its survey during the same week as the attacks, but that it counted people as employed if they worked even a small part of the survey week. As a result, the report said, the tragedy likely "had little effect" on the data.

That implies the October report will be a disaster. A job decline of another 250,000 or more cannot be ruled out. Jobless claims have soared since the attacks, and retailers, hotels, airlines, and entertainment companies have announced massive layoffs because fallout from the attacks curtailed their business. The October jobless rate is likely to jump above 5%.

YET AMID ALL THIS BAD NEWS, there is hope for the household sector. Consumers had already begun the process of shoring up their balance sheets and freeing up money for more spending later on. This reliquefaction process is possible only because of fiscal stimulus and the extremely accommodating moves by the Fed that were in place before September 11.

First, the downturn in mortgage rates, triggered partly by Fed rate cuts and partly by federal surpluses, produced a wave of refinancings this year that have lowered monthly mortgage payments. For instance, a homeowner with an old, 30-year mortgage of \$100,000 at 8% could save \$100 per month by refinancing at the current 6.5% rate.

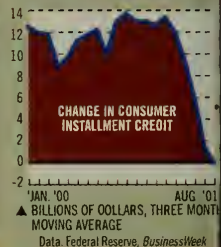
Second, consumers seem to be using their tax rebates

to improve their balance sheets. The savings rate jumped to 4.1% of aftertax income in August thanks to the inflow of rebates. Moreover, consumers are harrying their credit cards to shop. Installment debt not grow over the summer (chart). This means that the future, less of the average consumer's monthly budget will have to be used to repay old debts.

Lastly, Washington seems to understand the need to focus policy on helping consumers. Extended jobless benefits and tax cuts are geared to keeping households afloat in these treacherous times. The danger is that Congress will go overboard, if special-interest groups bloat the stimulus package with pork-barrel projects (page 46). That could lift long-term interest rates and curtail private investment.

More likely, however, fiscal prudence will prevail, weak demand will allow inflation to edge lower, enabling long-term rates to decline. Indeed, the Fed has learned a key lesson over the years: Low inflation creates greater policy flexibility. That room to maneuver, plus past fiscal discipline, means that Washington can concentrate its energies on pulling this economy out of its downturn.

A CHANGE IN BORROWING HABITS



BRAZIL

A PLUNGING CURRENCY AND A TRAPPED ECONOMY

Brazil's economy is caught between a rock and a hard place.

Prior to September 11, an energy crisis and worries about Argentina's debt problems had sapped output, weakened asset prices and the currency, and discouraged foreign investment. Now, a global recession, investors' new aversion to risk, and even weaker capital inflows are making matters much worse.

Brazil's central bank on Sept. 28 lowered its forecast for 2001 economic growth to 2%, but most private forecasters now expect growth of less than 1% this year, implying a second-half recession.

The problem: The Brazilian real's 28% plunge vs. the dollar

this year has frozen interest-rate policy. Rates, which are at 19% in order to support the currency, cannot be lowered for fear of further weakening the real and fueling already-rising inflation. Raising rates to shore up the real and attract investment would only further damage growth prospects.

Brazil's dilemma stems from the financing requirements of its massive external debt, some 7% of gross domestic product, set against the domestic financing needs of both the government and businesses. But sources of finance are drying up. Investors' flight to safety has hit both foreign direct investment (FDI) and short-term portfolio in-

vestment. FDI had been sufficient to cover Brazil's entire current-account deficit of about \$24 billion this year. Now, FDI is expected to drop to about \$20 billion this year and to just \$12 billion in 2002, according to Standard & Poor's Corp. Plus, stock prices this year are down more than 30%—more than 50% in dollar terms. Fading exports are cutting into that source of finance, as well.

These problems are compounded by the government's lack of haste in addressing its fiscal imbalances. The government on Oct. 1 drew down \$4.7 billion of its latest \$15.5 billion loan from the International Monetary Fund. Ultimately, Brazil may be forced to tighten both fiscal and monetary policies in order to correct its imbalances, but that would come at a severe cost to the economy.

THE CURRENCY REFLECTS BROADER PROBLEMS



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business
thought:

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best use
of your company's
time and money?

hint:
it isn't
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WHAT'S AT

HOW TERRORISM THREATENS THE GLOBAL ECONOMY

For an already traumatized nation, America seemed to take the Oct. 7 news that the U.S. had begun bombing Afghanistan in stride. Stock prices slid, then recovered in the days that followed. Retailers reported that shoppers were still showing up at malls. CEOs exuded confidence that lower interest rates and fiscal stimuli had set the stage for a strong recovery sometime next year.

That also was the market-soothing message the Group of Seven industrial countries sought to project on Oct. 6, the eve of the U.S. strikes. At an unprecedented joint press conference at a Washington conference center, where reporters first had to pass through metal detectors and be checked by bomb-sniffing dogs, finance ministers and central bankers from the U.S., Europe, and Japan assured investors that the global

economy will shake off its malaise and snap back smartly next year.

It's a brave front. But lest anyone believe the U.S. and the rest of the world can rest easy, Treasury Secretary Paul H. O'Neill threw in a major caveat. "We have a new kind of uncertainty to deal with. It probably was always present, but we never reflected it in our markets because it was such a remote possibility." Behind closed doors at the Treasury Dept. earlier that day, Federal Reserve Chairman Alan Greenspan was more explicit. He spoke at length with G-7 officials about the economic costs of business anxieties caused by the threat of terrorism. Greenspan noted that the cost of capital is rising as investors demand higher returns to account for bigger risks. The evidence: steep drops in glob-

al equities and sharply higher interest rates for bonds of emerging markets and all but the most solid corporations.

Even as the war heats up, many corporate bosses, especially in the

warn against excessive gloom. "We have not curtailed things. We haven't pulled the sheet over our head,"

THE AFTERSHOCKS

William R. Johnson, CEO of food and H.J. Heinz Co. Despite early shipping bottlenecks for parts and supplies, manufacturers such as Ford Motor Co. and Flextronics International Ltd. in the hiccups haven't seriously disrupted their businesses. And leading multinationals vow that fears of travel and violence won't make them retreat from foreign markets. "This hasn't changed the way I feel about the need to globalize," says new General



mean that even when the U.S. emerges from recession, it will be hard-pressed to return to the 4% baseline growth rate it achieved during the go-go years of the 1990s. In short, America's golden age of prosperity—and the promise it held for global growth—may have hit its zenith.

The reason is that one of the chief casualties of this new era of insecurity is the very ideal of free-wheeling globalization that emerged in the past decade. Economists, including Allen L. Sinai at consultant Primark Decision Economics Inc. in Boston, figure that the freer flow of goods, capital, and people made possible by the dismantling of global trade-and-investment barriers contributed a good three-quarters of a percentage point to annual U.S. growth over the last half of the decade. Open global markets led to a boom in trade, which swelled

der inspections could slow movements of cargo, forcing companies to stock more inventory. Tighter immigration policies could curtail the liberal inflows of skilled and blue-collar laborers that allowed companies to expand while keeping wages in check. Meanwhile, a greater obsession with political risk has companies greatly narrowing their horizons when making new investments. "What drove the rapid expansion in trade and capital flows was the notion that the world was becoming a seamless, frictionless place," says Morgan Stanley Dean Witter & Co. Chief Global Economist Steven S. Roach. "Now, there's sand in the gears of cross-border connectivity. That's a huge tectonic change in the global landscape."

PLUGGING HOLES. Perhaps the best evidence of this cautious new era is the marked shift in U.S. foreign policy. After the end of the cold war, promoting economic interests became the top goal of American diplomacy as Washington mobilized to export its own model of open markets. But in these times, unfettered openness conflicts squarely with

Washington's new priority on security. It's certainly a different world from the 1990s, when "the goals of American diplomacy and business were in sync," recalls Yale School of Management Dean Jeffrey E. Garten, who as a Commerce Dept. official in the first Clinton

Administration led the U.S. trade push in emerging markets. "Now, instead of knocking down new barriers, foreign policy will likely be more focused on addressing the many holes and vulnerabilities in the system. This is what will have to happen in this new war."

Greenspan's concerns are just one hint that the carefree nature of globalization has taken a severe jolt. You sense it from an executive of a major U.S. airline who says his carrier's flights to London have been half-full since the U.S. bombings began. "International travel will tank if the terrorists retaliate," he says. And United Technologies Corp. CEO George A. David says: "We took a blow to confidence as a nation. People don't do discretionary things,

ON THEIR WAY

If the fight against terrorism is protracted, globalization will become slower and costlier

from 18% of global economic output in 1990 to 26% in 2000. Globalization helped disseminate investment capital, technology, and entrepreneurial ideas far and wide. It lowered prices for consumer goods, enabled

manufacturers to boost productivity with just-in-time supply chains, and opened vast pools of technical talent to Silicon Valley.

Globalization certainly isn't going to disappear—the world's markets are too vitally integrated to roll back now. But globalization could well become slower and costlier, crimping the high-productivity, low-inflation model of the 1990s. Companies will likely have to pay more to insure and provide security for overseas staff and property. Heightened bor-

Co. Chairman Jeffrey R. Immelt. Yet if Greenspan's hunch is correct, the implications are far-reaching. What the war against terrorism is a protracted affair and terrorists manage to wreak more large-scale havoc in the U.S. and Europe? As companies worry more about the safety of their staff and facilities, the free flow of people and goods could slow, hurting economic efficiency. Because of the higher cost of capital, investment won't return to pre-9/11 levels. That, in turn, could

A DEEPENING GLOBAL SLOWDOWN

	UNITED STATES		EUROPE		JAPAN		LATIN AMERICA		NON-JAPAN ASIA	
ESTIMATED GDP GROWTH	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002
PRE 9/11	1.3	2.7	1.8	2.5	-0.8	0.2	1.3	3.3	4.5	5.8
POST 9/11	0.9	1.0	1.6	1.5	-0.9	-1.0	0.7	0.7	3.6	4.5

Data: Morgan Stanley & Co.

and they don't go to strange places. Travel is all about strange places."

You can see it on the U.S. border with Mexico, where cargo-laden trucks take up to seven hours to make the crossing, compared with one or two hours a month ago, now that tighter security policies require that every single vehicle and container be opened and inspected. "If you go to Laredo, [Tex.] the busiest cargo border crossing, you'd be astounded—it looks like some of those trucks are trying to cross the Iron Curtain," says Richard N. Sinkin, managing director at San Diego-based manufacturing consultant Inter-American Holdings Co. You also hear it from foreign-born entrepreneurs such as Vivek Wadhwa, CEO of Cary (N.C.) software company Relativity Technologies. Wadhwa, a native of India, says he was forced to show I.D. to a retail clerk who thought he was an Arab—and accused him of shoplifting. "You people think you can come to our country and do what you want," said the staffer, threatening to call the cops. Says Wadhwa: "I think America is going to look inward now. It's a different country."

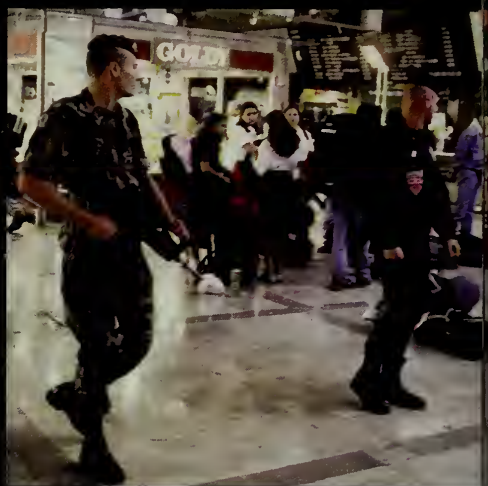
FEWER VISAS. Anxiety is just as palpable abroad. In Britain, fears of attacks have sparked a run on gas masks and made the financial-services industry "distinctively nervous," says PricewaterhouseCoopers partner John Hitchins. In India, execs fret that a U.S. clampdown on visas for the nation's software engineers, plus a new wariness of outsourcing sensitive work to foreigners, could severely damage the nation's thriving information-technology services industry. And with security specialist Kroll Associates ranking India just below Afghanistan in political risk because of terrorist threats and possible war with neighboring Pakistan, execs fear new foreign investment will grind to a halt. "Economically, the world will be divided again," says a Bombay-based U.S. telecom exec. And in once-stable Indonesia, mounting signs of radical Islamic unrest aimed at U.S. and British interests have expatriates packing their bags.

Needless to say, it's not an environment that fosters global commerce, especially since economies were slowing well before September 11. HSBC Holdings forecasts that global trade, after surging 12.6% in 2000, will expand a mere 0.9% this year and just 2% in 2002. That should translate into weaker growth.

A major reason is that higher risk

WHEN SECURITY CRIMPS OPENNESS

Data: BusinessWeek



PATROLLING A RAILWAY STATION IN PARIS

FREEDOM OF MOVEMENT Short-term, business travel will be severely curtailed, making cross-border collaboration and sales efforts harder. Longer-term, the cost of insuring the safety of managers and workers traveling abroad will rise.

IMMIGRATION FLOWS Any clamp-

down on immigration could hurt the U.S. economy, which relies on immigrants for both blue-collar labor and high-tech skills.

OPEN BORDERS Over the long term, heightened border security worldwide will slow air and sea shipments. That could slow

means higher costs. Just as insurance costs for Central London offices leaped fourfold after the Irish Republican Army bombings in the early 1990s, rates are likely to leap for companies with properties anywhere terrorism is a threat. Liability insurance for staff will rise, too. "These costs will have to be passed on through product prices and will force companies to rethink where they should be doing business," says insurance and risk-management professor Jerry S. Rosenbloom at Wharton Business School. "The impact will be felt throughout the world."

If disruptions at border crossings become a fact of life, companies will have to stockpile more spare parts, which hikes costs further. Hundreds of U.S. companies with manufacturing or assembly operations in Mexico, from major Detroit auto makers to data-processing companies, are rethinking their logistics. Auto-parts maker Delphi Automotive Systems Corp., which runs 56 plants in Mexico and moves 200 trucks across the border each day, has started shipping

parts in smaller lots and is dispatching trucks more frequently. If there's a delay at the border, "we could redirect shipments to a plane, boat, or helicopter," says Mark Lorenz, Delphi's vice president for logistics. Before September 11, Delphi's worst-case scenario was strikes by dockworkers or truckers

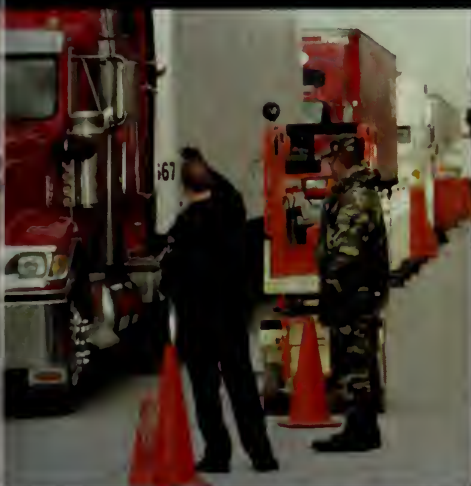
Brazil or France. "We never really planned for this kind of event," says Lorenz during the Gulf War, he says.

Tighter U.S. immigration policy could also develop in the wake of the war. Swelling immigration played a key role in the success of the New Economy. It helped hold down labor costs, allowed the economy to grow faster and longer without igniting inflation. Immigrants, who accounted for two-thirds of the record inflow of 14 million foreign nationals in the 1990s, accounted for half of workforce growth over the decade. Some 30% of Silicon Valley startups are founded by ethnic Chinese or Indian.

But a chill is settling over U.S. immigration policy. In the short term, America will tighten border security

THE AFTERSHOCKS

"The world was becoming a seamless, frictionless place," says



CHECKS AT THE U.S.-CANADIAN BORDER



MAKING BARBIES FOR MATTTEL IN JAKARTA, INDONESIA

supply chains that rely on shipments to keep factories alive, thereby forcing companies to stock more inventory.

TRADE Even before the war, movement to liberalize world trade had stalled. Now, talks on new deals seems

unlikely. Why that's bad: Globalization added three-quarters of a point to U.S. growth every year in the 1990s.

GLOBAL INVESTMENT Protecting corporate assets overseas will become a priority. Some investments, particularly in high-risk countries

such as Indonesia or the Philippines, will be deferred or canceled.

COST OF CAPITAL Companies that still invest in emerging markets will see the cost of their capital rise as lenders add a new risk premium to funds. The higher costs could slow global investment flows further.

antiterrorist legislation pending in Congress would triple the 334 Border Patrol agents who police the 4,000-mile border with Canada—and crack down on the thousands of visitors who overstay their visas. Harsher measures are cooking on Capitol Hill. Representative Tom Tancredo (R-Colo.) has introduced a bill that would halt all immigration for six months. Senator Arlen Specter (D-Calif.) is pushing for a six-month moratorium on all student visas to give the Immigration & Naturalization Service time to put a formal student-tracking system in place. The worry is that curbs on immigration will come back to haunt the U.S. economic boom of the late '90s. "Probably never would have happened if it were for the immigrant flows," says Mark Zandi, chief economist at consulting firm Economy.com Inc. "The next quarter-century will be marked by a lack of skilled labor, especially in tech fields," because of America's aging workforce. Just as the U.S. is rethinking immigration policy, companies are contemplating a globalization that is less global. Despite what companies say about

not changing any plans, curtailment of overall foreign investment is already under way. Few companies will admit they're giving up on a country, especially if they've already invested serious capital. But Vince Tobkin, Bain & Co.'s top IT consultant, says corporations are flocking to only a handful of nations—such as China, South Korea, and Mexico—that are seen as stable and growing. Any place that smacks of political instability, has a volatile currency, or simply has lackluster growth prospects is off the map of most multinationals. Most of the Arab world is seen as toxic. And parts of Latin America and Southeast Asia, including Indonesia and the Philippines, also are off-limits.

That's why restoring confidence in the safety of the global economy is emerging as a vital challenge for the Bush Administration as it wages war on terror. Treasury and Congress are working with U.S. banks to devise better ways to police money-laundering for global crime syndicates without overly interfering in markets. U.S. Customs is racing to implement new technologies that can electronically monitor car-

go shipments without completely clogging borders. And U.S. Trade Representative Robert B. Zoellick is working to make sure the World Trade Organization summit in Qatar, intended to launch a new global trade round, comes off on schedule in early November. "Because of the terrorist attacks, the major trading nations have shown more determination to push on with the trade agenda," says WTO Director-General Designate Supachai Panitchpakdi.

But with unresolved issues ranging from agriculture to antidumping rules, it's far from clear that a WTO meeting will be successful, if it takes place at all. In this new environment, how many nations have the stomach for measures that could cause disruptions? Openness was the ideal of the 1990s. Now, safety is paramount. The task is to secure both. The future of global prosperity depends on it.

By Pete Engardio in New York and Rich Miller in Washington, with Geri Smith in Mexico City, Diane Brady in New York, Manjeet Kripalani in Bombay, Amy Borrus in Washington, Dean Foust in Atlanta, and bureau reports

gan Stanley's Roach. "Now, there's sand in the gears"

U.S. POLICY

FIGHTING A SPREADING FIRE

As world Muslims react to the air strikes, the Bush Administration struggles to control the backlash

Such a small war, such massive repercussions. Just two days into the U.S.-British assault on the Taliban regime in Afghanistan, the number of bombing sorties had dwindled to a handful—as the list of military targets shrank. The most intense action raged elsewhere. In a shock wave rippling out from Afghanistan to the far reaches of the Islamic world, the American-led intervention ignited fury and cries of *jihad*.

In the Pakistani city of Quetta, mobs burned a UNICEF office and a theater that showed American films. In nearby Kuchlak, police fired on a crowd of several hundred demonstrators, killing three. In Gaza City, Palestinian leader Yassir Arafat shuttered two religious universities amid rioting that resulted in the death of two protesters (page 44). And in Indonesia, militants vowed to “sweep” the nation clean of Americans and Britons, while police used water cannons to break up a crowd threatening the U.S. Embassy in Jakarta. Even the moderate Indonesian Council of Ulemas, which oversees the National Mosque in Jakarta, urged the government to sever its ties with Washington.

Somewhere, Osama bin Laden must be smiling—because the first phase of the U.S. attack on terrorism is igniting a new firestorm of anti-Western hatred. “It’s a propaganda battle for the hearts and minds of Muslims, and the West has lost,” says Nadim Shehadi, director of Oxford University’s Center for Lebanese Studies.

ON THE MARCH. That may be far too bleak an assessment for a campaign that may take years to bear fruit. But there is growing concern from Malaysia to Morocco that the intensifying battle against terrorism risks sowing instability through the already shaky Islamic world, creating thousands of angry new recruits for tomorrow’s suicide missions.

The prospect of Islamic militants on the march has consequences that go far beyond a U.S.-orchestrated drive to stamp out bin Laden and his network. The longer the military action drags on—with a likely increase in Afghan civilian casualties—the greater the

THE AFTERSHOCKS

threat to moderate Islamic regimes that have reluctantly signed up with the West. Case in point: Egyptian President Hosni Mubarak, on the surface one of the more entrenched leaders, nevertheless flew to Europe soon after September 11 to voice concern about a possible *putsch* in his country. There is “a race between a political solution in Afghanistan and everything else in the Middle East busting apart,” frets Ghasan Tuani, publisher of the *al Nahar*



newspaper in Beirut and a former Lebanese Cabinet minister.

The challenges for U.S. policymakers are huge and intractable. Washington will need to formulate more effective policies for dealing both with flare-up of violent extremists who cloak themselves in the Koran and with the root causes of their radicalism. The challenge is not only neutralizing bin Laden and his al Qaeda network but also dealing with countless Muslims like 17-year-old Pakistani student Yassir Mahmood. On Oct. 8, he took to the streets of Rawalpindi with a poster saying: “I am a *Jihad*.” Vows Mahmood: “For Islam will die. We will fight against America anywhere in the world.”

The Bush game plan includes close political and military ties with gov-

THE WAR IT COULD BE LONG, BLOODY—AND INDECISIVE

The U.S. and its allies face several complex outcomes in the wake of opening strikes against Afghanistan. None is clear-cut. Here are a few possibilities:



THE NOT-SO-QUICK KILL

Allied bombing sends the Taliban scurrying. Northern Alliance insurgents secure the country. U.S. troops eventually snare Osama bin Laden and destroy his bases. **Cost:** U.S. casualties; the martyrdom of bin Laden, spurs new terrorist attacks; domestic pressure to take the war on terrorism to countries such as Iraq, Indonesia, and Malaysia.

A LONG GOODBYE

U.S. forces fail to capture bin Laden—after months of painstaking, cave-by-cave searching. Critics warn that the U.S. is being drawn into a Vietnam-style quagmire. Reports surface that bin Laden has a new country, promising to reconstruct his terror cells. **Cost:** Strains on any coalition; threats of new terror attacks.



Mideast peace process in hopes of forging a deal between Arafat and Israeli Prime Minister Ariel Sharon. That will entail resolving such emotional issues as the future of Jerusalem, claimed as the eternal capital by both sides. Without an accord, "the fight against terrorism won't succeed," says Steffen Angenendt, a senior fellow at the German Council on Foreign Relations in Berlin.

Bush's other challenges are equally daunting. To overcome a sense of powerlessness and abandonment among the Islamic masses, the West may seek to build viable economies in poverty-stricken nations such as Pakistan and Jordan. To do that, the American-led coalition will be pressed to pour billions into economic development and education. "If you diagnose the problem as ethnic and religious conflict, you are writing

PAKISTANIS PROTEST

The Allied bombing is igniting a firestorm of anti-Western hatred in the Islamic world

"incurable," says S. Frederick Starr, a Central Asia specialist at Johns Hopkins' School of Advanced International Studies. "If it is in fact an issue of underdevelopment [and] poverty, then it is something we can deal with."

Starr and other academics say a little money can go a long way. For example, irrigation ditches and higher-quality seed have improved the standard of living in northern Pakistan and Pakistani parts of Kashmir, which had been hotbeds of religious radicalism. "They have really turned this region around over a 20-year period," Starr says.

PURITANICAL. Even if Western governments increase development aid—not a sure bet, given the downward glide of industrialized economies—many problems will be difficult to tackle. Consider, for example, the case of poor or nonexistent educational systems in many places in the impoverished Islamic world. The failure of the secular school systems in these nations has prompted many poor families to turn to religious institutions known as *madrasahs*, some of which are run by radical sects that are virulently anti-Western and anti-Semitic.

One source of the puritanical academies' financial backing is the Saudi Arabian government, which spends about \$10 billion a year promoting Wahhabism, a fundamentalist sect of Islam. "In countries like Pakistan, the secular state education system has been failing for 20 years," says James Clad, professor of South-

nts at risk. And the President has related from ideological resistance to textbook diplomacy, backing multilateral aid for economic reform and development. The hope: The masses will pick sides over *jihad*. "There is a heavy economic component to this strategy," says senior Bush Administration official. But the White House is also ditching political reform as it focuses on defeating terrorism. "At a time like this, under extremist pressure, we don't want to destabilize friendly governments," says the official. Some fear this approach could come back to haunt the West. These countries "need extensive political reform to root out corruption," says Terence Taylor of the International Institute for Strategic Studies. Yet as the White House War Cabinet

confronts a new set of strategic imperatives, the first challenge is clear: to cut the lifeline of global terrorist networks by dispatching bin Laden or rendering his organization incapable of mounting large-scale operations.

The next phase will be far more controversial within the alliance because it could mean moving against other countries that harbor extremists. While bin Laden seeks to frame the American intervention as a clash between Islam and infidels, Bush must redouble efforts to show that his enemy is apostate terrorists and not Koranic true-believers.

One key element of gaining credibility with the moderate Arab world will also be among the toughest: In a firm and balanced fashion, the President must renew U.S. efforts in the stalled

THE BIG WIN

The Taliban collapses—as U.S. and British commandos root out the al Qaeda network. With bin Laden gone, moderate Muslim regimes grow stronger, and fundamentalist groups wither. U.S. pressure prompts new treaties between Israel and the Palestinians. U.S. forges warmer ties with Russia, and Iran. **Cost:** huge increases in economic and military aid.



OSAMA'S REVENGE

Bin Laden is taken, but Islamic extremists from Pakistan to Indonesia foment uprisings. Some alliance governments topple, and threats of anti-Western insurrection grow. **Cost:** Allies enter a new cold war; the world economy suffers from instability in the oil-producing Middle East; Israelis and Arabs go to war.

When a few armed zealots humiliate the sole superpower other people who want change at any cost take notice

east Asian studies at Georgetown University. "We could help turn that around by providing economic aid, working with the World Bank and even institutions of moderate Islam."

No policymaker thinks there are any quick fixes that will end the threat of violence overnight or douse the flames of rage in the streets of Islamic countries. Even the first phase—shutting down terrorist cells—will be a slow, broad-based effort that resembles the decades-long cold war, says Defense Secretary Donald H. Rumsfeld.

There's another, more troublesome cold war parallel: To combat this new adversary, Uncle Sam is willing to make alliances with some unsavory regimes. In the past, that meant cozying up to despots in Latin America, Southeast Asia, and even Afghanistan. Now, the U.S. is siding with oppressive governments in Islamic countries, including the military dictatorship in Pakistan and the authoritarian government in Uzbekistan. Trouble is, this short-term expediency could create a backlash down the road, leading to fundamentalist coups against pro-Western autocrats similar to the 1979 Iranian revolution. "The more we wink at [these regimes] and hold their hands and give them aid, the more angry the population becomes," warns Geoffrey Kemp, a former Reagan Administration official.

The risks to these U.S. allies depend heavily on how swiftly and successfully the anti-terrorism campaign is conducted. The best-case scenario would involve the quick ouster of the Taliban, rapid elimination of bin Laden's al Qaeda network, and minimal civilian casualties—a key goal of the Pentagon's initial bombing campaign. The success of such a blitzkrieg against bin Laden would pay other dividends, as well. Moderate regimes throughout the Muslim world would probably be strengthened, and the U.S. could count on improved relationships with Russia and even Iran in an ensuing Big Thaw.

Such a victory wouldn't be cheap,

however. The price: huge increases in U.S. economic and military aid to new allies and old Arab friends alike and a far greater reliance on multilateral decision-making than the independent-minded Bush team would like.

If victory takes longer and if terrorists are able to find sanctuary elsewhere, pressure on Bush would grow to expand the campaign to other countries

dampening effect on opponents," the senior Administration official we look like we are losing, then a moderate government on the plan in trouble."

The costs of this spreading conflict could be huge, complete with an arms buildup. The world economy would take a hit from instability among producers. And if Israel feels that

ened, the hawkish Shimon Peres might launch a pre-emptive strike against Arab neighbors.

Only a few doomsayers believe this is the way things will evolve. But in the short run, bin Laden's audacious attack—plus Bush's tough retaliation—could create a new wave of instability. "There's a chance that a few people in



that continue to sponsor terrorism. The most likely new target would be Iraq. To prepare for that possibility, Washington notified the U.N. Security Council on Oct. 8 that it reserves the right to pursue terrorists beyond Afghanistan. Such an escalation could split Bush's coalition and further inflame Islamic passions. Harsh new terrorist attacks in the West and possibly efforts to disrupt the flow of Middle East oil supplies would also become more likely.

The worst-case scenario is grim: It has bin Laden continuing to elude his American pursuers and the U.S. drawn into a Vietnam-style quagmire in

Afghanistan. As casualties—both military and civilian—mount, Islamic extremists from Pakistan to Indonesia would probably foment uprisings. Some alliance governments would fall, and the threat of a general anti-Western insurrection throughout the Islamic world would grow. Particularly at risk is Saudi Arabia, whose ruling dynasty's close, decades-long ties to the West have riled the nation's large cadre of fundamentalists. "If we look like a winner, this gives courage to governments and has a

turn to fundamentalist academics—usually virulently anti-Western

knives humiliated the sole superpower and changed the whole international order is inspiring to some hopeless people who want change at any cost," says Imtiaz Ghani, a government professor at the University of Maryland.

When Bush first began huddling with his campaign foreign-policy advisers, what seems like a lifetime ago in Austin, Texas, he had no inkling that leading a global campaign against terrorism would become his Administration's dominant concern. Now, the events of September 11 have transformed both Bush and his policy, and the Administration is starting to realize that beyond the fight with bin Laden, the struggle against a passionate and fanatical movement. It is a struggle that America must win, as Bush keeps repeating, if only because the stakes are so enormous.

By Stan Crock, Richard S. Dorn, Alexandra Starr, and Lee Waleza in Washington, with Frederik Balfour in Islamabad, Michael Shari in Jakarta, Stanley Reed in Cairo, John Rose in Paris, and bureau reports

LEARNING RELIGION

With state schools poor, Muslims often

THE AFTERSHOCKS



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IN TAJIKISTAN, CALLS FOR A JIHAD FALL ON WEARY EARS

Students went to class. Shops opened. And at the largest mosque in Dushanbe, capital of the former Soviet Republic of Tajikistan, just a few hours' drive to the border with Afghanistan, no one seemed ready to enlist in the *jihād* declared by Osama bin Laden against America. "I have a very negative attitude towards war," said Nazarov Pirumsho, the mosque's 69-year-old security guard.

Strange as it may sound, it was pretty much business as usual in Tajikistan the day after the U.S. military began its Oct. 7 bombing raids in Afghanistan. Pakistan and other parts of the Islamic world faced upheaval. But not, so far, this particular patch of ground, a possible launching pad for U.S. operations against the Taliban and bin Laden. Still recovering from a civil war in the last decade that claimed 60,000 lives and spawned 500,000 refugees, Tajikistan is suffering from combat fatigue. Prominent Islamic militants and the ex-Soviet communists they fought in that conflict are now part of a coalition government. The factions are not exactly friends, but at least they are no longer sworn enemies. For most people in this desperately poor country—population 6.2 million, average monthly salary \$10—that's good enough.

But just as there is little sympathy in Tajikistan for Taliban militants, the arrival of American warriors to the neighborhood wins no great applause, either. For one thing, there is little popular expectation that the Pentagon can achieve its declared goal of expelling the Taliban from Afghanistan. In a computer-parts store on Rudaki Street, the main thoroughfare in Dushanbe, a trio of voices shout "no" when the question is put whether the U.S. military will win this fight. Americans, one member of the group says, have no real idea of what they

face in the Taliban—only the latest in a long line of fierce Afghani fighters who defeated the Soviets in the 1980s and the British in the 19th century. Other locals say the American public must brace itself for grisly war crimes, such as a public display of a captured U.S. soldier who has been tortured—or even beheaded.

Russian troops, 17,000 of whom are stationed in Tajikistan to guard the

border with Afghanistan, share doubts over U.S.

That, of course, remains to be seen. In the meantime, Tajikistan may find itself pulled into the conflict. Thousands of Afghani refugees, now stranded on islands in the Pyandzh River that acts as a buffer zone along the Afghan-Tajik border, may break across to Tajikistan. Already, U.S. military specialists in search and rescue missions are operating in Tajikistan, say Russian defense officials in Dushanbe. The Russian military is backing the Northern Alliance, the Taliban's opponent. "It's possible," a Russian defense source says, the U.S. military will deliver Russian weapons to the Alliance using American helicopters that could be based in Tajikistan.

For that to happen, the U.S. would need to work out a basing agreement with Tajik and Russian officials. So far, Tajik President Imamali Rakhmanov has not gone beyond a public statement in favor of granting airspace to U.S. planes for humanitarian missions. But rumors are rife in Dushanbe that American troops will soon arrive in strength.

Whatever the verdict on bases turns out to be, it will no doubt be made above the heads of the citizens, who are seldom consulted in a country with a long tradition of authoritarian politics. If the Americans do come in numbers, the people can be expected to make the best of it—just as they are doing with the hordes of foreign

journalists stationed in Dushanbe, awaiting passage to Afghanistan. For a trip to the border, drivers make up to \$300—a phenomenal sum for most Tajiks. "Any kind of foreigner who comes to Tajikistan, including an American soldier, is a possibility to obtain a job," says Svetlana Nazarov, 49, an economist who makes ends meet by housekeeping for international relief workers in Dushanbe. One faint cheer, at least, for the coming of Americans to Central Asia.

By Paul Starobin in Dushanbe

THE AFTERSHOCKS



NEWS IN DUSHANBE

Rumors are rife that U.S. troops soon will arrive in strength for the campaign against the Taliban



nerve. The first wave of bombing strikes made little impression on the local garrison. That's because of the Russian army's view, formed during the U.S.-led NATO air campaign in Kosovo, that the U.S. military is afraid to risk casualties in ground combat. "They have all kinds of fancy equipment," says a 25-year-old private in the Russian 201st motorized division in Dushanbe, whose officers have participated in exercises with American soldiers elsewhere. "But they don't have the stamina," he adds.

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COMMENTARY

By Stanley Reed and Neal Sandler

A RARE CHANCE FOR ISRAELI-PALESTINIAN PROGRESS

Although the U.S.-led campaign against terrorism is just beginning, it could change the face of the Middle East. Saddam Hussein's regime in Iraq could become a U.S. target. Iran has made intriguing gestures toward the West. But the most important shift could well be in the Israeli-Palestinian conflict. Since the intifada began a year ago, the U.S. has its best chance yet to push for a solution to the Palestinian problem, as well as damp down the extremism it fuels throughout the Middle East.

Palestinian leader Yassir Arafat is signaling that he's ready to do business. After September 11, he publicly decried the terrorist attacks and declared support for the U.S.-led coalition to fight terrorism. Some observers viewed this as cynical. But in a stark break from recent practice, Arafat's police on Oct. 8 fired on Palestinians protesting in support of Osama bin Laden in the Gaza Strip, killing two and wounding dozens. "Arafat is sending a clear message that he will not tolerate any deviance from the Palestine Authority's position in support of the U.S. alliance," says Riad Malki, an independent Palestinian analyst in Ramallah. Arafat is keen to return to the negotiating table, ideally within weeks, he adds.

For George W. Bush, there may never be a better opportunity to make strides in fixing one of the world's most intractable problems. With his anti-terror campaign, he has seized the initiative around the globe. He should take advantage of this momentum to drive the Israelis and Palestinians toward a peace deal. That not only would be good in itself, it would also make it easier for the Administration to hold its anti-terrorism coalition together. "Even if Osama bin Laden and al Qaeda are eliminated, if nothing is done for the Palestinians, a new gen-



GAZA PROTEST

Arafat has cracked down on pro-bin Laden demonstrators

eration of Arabs will be more anti-Western than the previous one," warns Tahsin Bashir, a retired diplomat and former spokesman for Egyptian President Anwar Sadat.

Indeed, progress on the Palestinian question is one way the U.S. can ease pressure on allies such as Egypt and Saudi Arabia. Their citizens have been riled by satellite TV broadcasts of harsh Israeli tactics against Palestinians. They are skeptical about their governments' rallying to the U.S. cause against Islamic extremists while Washington continues to

back Israel despite its occupation of Palestinian territory. "The Arab moderates badly need progress for the Palestinians," says Mohamed Sid Ahmed, a columnist for Egypt's leading newspaper, *Al-Ahram*.

The rough outlines of an agreement are already on the table—a Palestinian state to be created from the West Bank, Gaza, and East Jerusalem. During his presidency, Bill Clinton tried hard—but failed—to persuade the Palestinians and Israelis to make concessions needed for a settlement. Now it will be up to

Bush. He will have to convince Israel to be more generous about Palestinian control over East Jerusalem. And the Palestinians will have to concede there can be no massive return of Palestinian refugees to Israel. **REPARATIONS.** To get both sides to agree to a settlement, Bush will have to summon all his authority as President. He can be expected to invoke the new global war on terrorism as the imperative for compromise. And he'll try to drum up tens of billions of dollars from Europe, the U.S., and Israel in reparations for displaced Palestinians.

But first Bush will have to get both Arafat and Prime Minister Ariel Sharon to the negotiating table. That in itself will be very tough, but Bush could achieve that by keeping up the pressure on Arafat to stop violence by militant Islamic groups, including Hamas and Islamic Jihad. If Arafat asserts control over the extremists, that would give Bush and his team leverage to pressure the hawkish Sharon to join the talks.

The trouble is both Arafat and Sharon face difficulties in dealing with extremists in their camps. Many Mideast observers doubt that Arafat can stop violence by the radical Islamic groups. Indeed, Palestinian TV on Oct. 8 warned of the danger of a civil war among Palestinian groups. Meanwhile, Sharon is under pressure from hard-liners in his coalition government as well as Israeli settlers who oppose a peace deal.

Despite the obstacles, Bush should push for peace talks as soon as possible. During the first few months of his Administration, he let Arafat and Sharon battle, hoping they would tire themselves out. The result was more violence. In the wake of September 11, Bush has strong reasons for putting all of America's weight behind a drive for Israeli-Palestinian peace. Let's hope he does.

Reed and Sandler cover the Middle East.

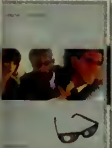
THE AFTERSHOCKS

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FISCAL POLICY

PARTISANSHIP CREEPS BACK INTO POLITICS

Bush and lawmakers tangle over the shape of the stimulus plan



In the mood of war-time resolve that has prevailed in Washington since the September 11 terror attacks, Republicans and Democrats have put partisanship aside to forge consensus on issues ranging from funding for the Pentagon to a bailout of the airline industry. Now the supreme test of this spirit of cooperation is at hand. Congress and the Administration have spent weeks trying to craft a stimulus package for the U.S., and with consumer confidence flagging and the economy contracting, both would like to complete a

plan within the next month. But as of Oct. 10, progress was stalling.

Sure, President Bush has signaled his willingness to accept up to \$75 billion in new anti-recession incentives. And the broad outlines of a deal have been reached. It will include tax breaks for both business investment and individuals, as well as aid for those who have lost their jobs.

But key details remain unsettled, and efforts to produce a package have been slowed by intraparty disputes and ideological differences among Democrats and

Republicans. The main sticking points: How much assistance should Washington give to the working poor; what tax break should be provided to spur new business investment, and how much spending should be included in a package that Bush wants focused on tax cuts. "The veneer of bipartisanship is not likely to stand up when you get into these kinds of issues," says Harry L. Gutman, partner with accountants KPMG LLP in Washington. Finding answers "will be contentious and not likely to happen real fast."

HIT FROM BOTH SIDES. One complication is that Bush is under pressure from all fronts. Conservatives are furious that the White House has missed the chance to cut both capital gains taxes and corporate tax rates. Reacting to the thunder on the Right, Bush has embraced another supply-side initiative—to accelerate individual rate cuts scheduled for 2004 and beyond. But that idea has been blasted by Democrats as an ineffective stimulus, since they believe upper-bracket taxpayers are unlikely to spend much of their windfall.

The complaints aren't just from Bush's right. Having acquiesced to big increases in Pentagon spending, Democrats are

SUNNYSIDE DOWN

Congressional leaders after breakfast with Bush, Oct. 10.

unwilling to embrace a stimulus plan that they feel is weighted heavily toward business and upper-income groups. They'll accept business tax breaks, but only if

they are packaged with new spending for dislocated workers. "We have soldiers in harm's way. You're not going to see the kind of pettiness that existed prior to September 11," says Senator Byron L. Dorgan (D-N.D.). "But that doesn't mean we won't be aggressive."

While Bush, too, has publicly toughened his stance on the tax cuts, congressional negotiators say he still seems to be trying to keep the post-September 11 bipartisan coalition from breaking up. Although his soaring popularity as Commander in Chief gives him powerful leverage over negotiations, so far at least, he has been re-

THE AFTERSHOCKS

AN END TO CONSENSUS

President Bush and Congress remain divided over several key issues of a fiscal-stimulus package

INDIVIDUAL BENNIES

Democrats want to give low-income workers an economic boost with a tax rebate. Bush favors accelerating top-bracket rate cuts that are scheduled to kick in in 2004 and 2006.

BUSINESS BREAKS

Hill Democrats, and even some Republicans, prefer temporary tax breaks aimed at encouraging new capital investment. The White House backs permanent tax incentives.

PUBLIC WORKS PROJECTS

Many on Capitol Hill would like to include \$15 billion in new money for roads, mass transit, and other big-ticket construction projects. Bush wants to limit a stimulus package to tax relief only.

"Users have found they can use a Web-enabled phone to access information, such as a list of wines for sale, but quickly lose interest when they discover that the next step is to shut off the phone and go to a Web site."

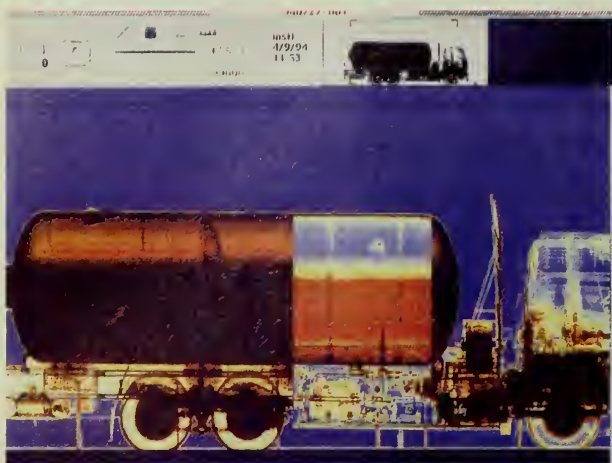
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that were never previously on the radar, says Stephen Flynn, a Coast Guard commander who studies shipping security as a senior fellow at the U.S. Council on Foreign Relations. For the federal inspectors, Job One is to alter their decades-old focus. To date, "they've been looking for bales of marijuana and bricks of cocaine, not biological or chemical weapons," says Kenneth G. Hawkes, a Miami-based maritime lawyer and consultant.

Port authorities will also have to untangle the overlapping activities of a half-dozen federal agencies, including Customs, the Coast Guard, the Drug Enforcement Agency, the Attorney General, and Treasury. Although some ports manage to balance the work of these agencies, none is truly secure, says Flynn. "There's a reason the Mob has always been active on the waterfront—it's an easy target," he snipes.

Better technology is bound to have an impact. Customs currently depends primarily on gamma-ray systems that are adequate for seeing through small vehicles or crates. But critics say these devices are most effective when applied to loosely packed containers. More powerful X-ray based machines, already used in Israel, the Netherlands, and Hong Kong, can pierce several inches of steel and peer through more densely packed boxes. These machines let inspectors scrutinize "everything from false compartments down to the buttons on a remote control," says John F. Moore, president of Bio-Imaging Research Inc. in Lincolnshire, Ill. And they can be programmed to spot tell-tale density signatures of explosive and nuclear materials.

Port authorities won't discuss their security strategies in detail. Since the attack, however, Customs has been on its highest level of alert. Long shifts

Industry experts now expect more high-end X-ray devices to be installed. However, even the fastest units, which cost upwards of \$10 million to fully deploy, can process only one container per minute. With thousands of containers passing every hour through 300 or more points of entry, "there's no way we can afford to install enough [scanners] to check them all," says Flynn. "It would mean gridlock at the borders and the end of trade."

It may not be necessary to inspect every box, though. Customs already sifts through shipping documents and intelligence tips to spot potential threats before container ships dock, says Michie. And with special software, port authorities may be able to further hone their skills in identifying suspicious boxes. In the world of cross-border trade, these programs are known as global logistics solutions and are sold by a host of software startups such as Vastera, NextLinx, ClearCross, Qiva, and Open Harbor. The systems track the deluge of details associated with each freight load, including the shipper, the carrier, the goods, bills of lading, and the like. "It helps to determine quickly if data is missing or suspicious," says Adrian Gonzales, an analyst with Dedham (Mass.)-based ARC Advisory Group Inc.

Keeping track of the people transporting the goods is also part of the challenge. Here, biometric systems that match physical features such as retinal patterns and facial structure may be

TANKER VIEW

X-rays can show what's inside a truck

are now the rule for inspectors, with the agency spending \$5.5 million per week for overtime. "We've effectively multiplied our force," says Customs spokesman James F. Michie.

of service. Biometrics could be used for example, to control access to secure areas and to avoid use of false I.D.s by truck drivers, stevedores, and even bogus Customs officials. Interstate truckers are already federally licensed. Extending this practice to the waterfront and adding background checks and I.D. cards that involve biometric verification isn't much of a stretch. And it would help secure port areas now protected by guards who are likely to be "half asleep and poorly paid," says Hawkes.

THIN WALLS. Security experts also fret about the physical integrity of the containers. The boxes look sturdy, but their steel walls can be deceptively thin. And they're often secured by little more than a padlock and a plastic tag that acts as a seal. Flynn points out that thieves have been known to clip and replace the tag, cut a hole in the roof—or even lift the rear doors from their hinges, remove the contents, and replace the doors without disturbing the seal. Estimates of the annual cost of such theft run as high as \$12 billion.

Fanatics, obviously, could employ the same tricks to far more sinister ends. But security experts note that shippers are already fighting back, to a limited degree, with wireless anti-tampering

devices. These include temperature and light sensors that can alert container owners of sudden environmental changes and global-positioning systems that warn authorities if a container is improperly removed from a secure area.

Lawmakers are racing to set up guidelines and funding for such technologies, along with im-

proved monitoring and tracking. One proposal from Senators Ernest F. Hollings (D-S.C.) and Bob Graham (D-Fla.) sets guidelines for loan guarantees, coordination among agencies, and national security standards. Last year, port managers resisted such efforts, but today, "it's a different story," says Kurt J. Nagle, president of the American Association of Port Authorities. The bill for a security upgrade may easily reach into the billions of dollars. But few will object if the funds can actually secure America's ports, roads, and rails.

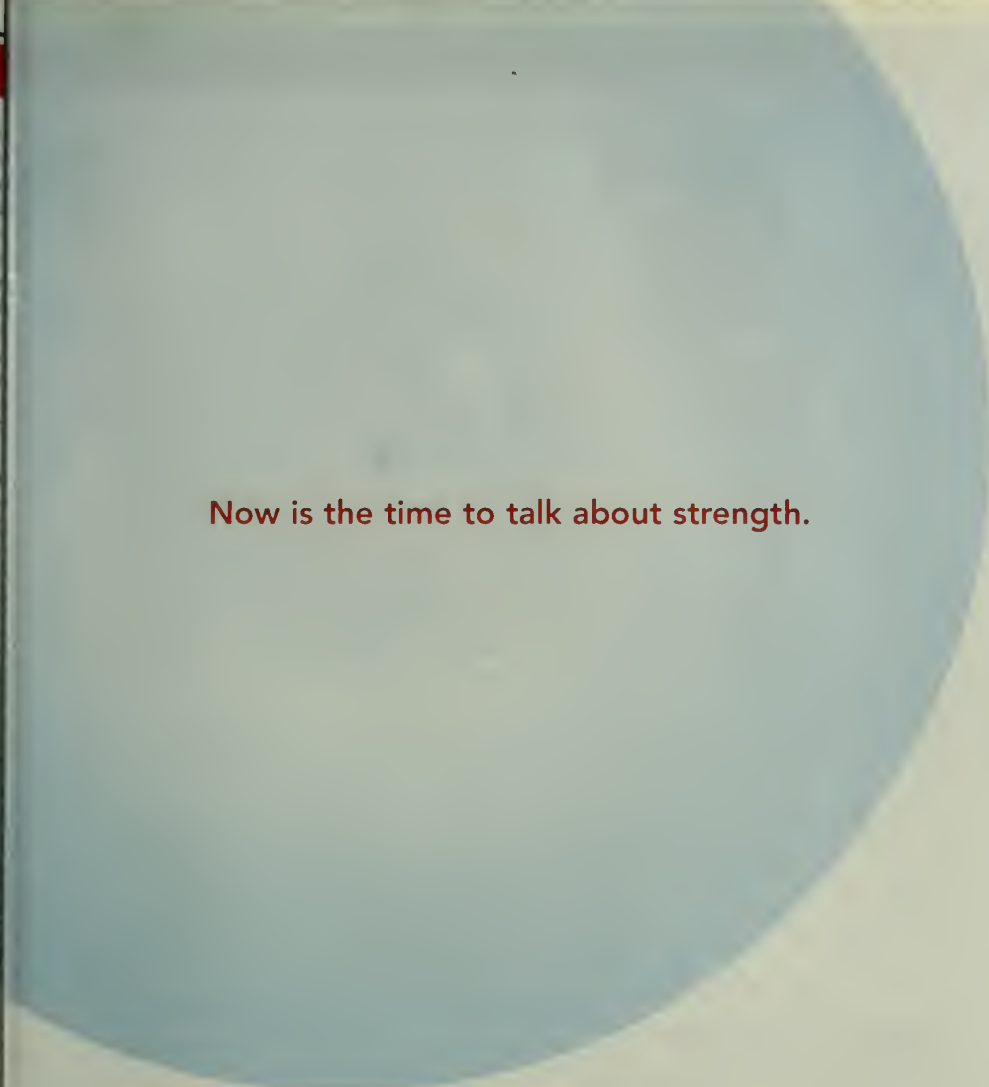
By Adam Aston, with John Cady, in New York

COMING TO AMERICA

Every day last year, Customs processed an average of:

- 1.3 million people
- 348,000 private vehicles
- 38,000 trucks and railcars
- 16,000 containers on 600 ships
- 2,600 aircraft

Data: U.S. Customs Service, BusinessWeek



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TERRORISM

PREPARING FOR A CYBER-ASSAULT

Fortification of the Web has become a top priority

With U.S. and British forces bombing the Taliban and Osama bin Laden's training camps inside Afghanistan, U.S. officials are bracing for other terrorists attacks. But it's not just physical attacks they're worried about. Law enforcement and security experts are increasingly concerned that the U.S. and its allies could be in for cyber-assaults as well. Shortly after the attacks on the World Trade Center and the Pentagon, the FBI issued a warning to tighten computer security. And on Sept. 22, the Institute for Security Technology Studies, a government-funded research organization at Dartmouth College, put out a report warning that cyber-attacks, ranging from defacing Web sites to undermining America's critical information systems, could be launched by terrorists or hacker sympathizers.

No one expects a digital Armageddon. But the guardians of the Net are on alert. On Oct. 1, the FBI, along with private security experts, took the unusual step of publicizing the top 20 ways that hackers tamper with computer systems. The goal: Make companies aware of potential weaknesses so they know what steps to take. Richard D. Pethia, director of the CERT Centers, a government-funded computer security organization run by Carnegie Mellon University, took a similar message to Capitol Hill on Sept. 26, testifying that hacker tools are getting more sophisticated and easier to use. Couple that with a recent General Accounting Office report noting that computer systems at all 24 federal agencies it probed are



"riddled with weaknesses," and it's no wonder that on Oct. 9 the Bush Administration appointed Richard Clarke, head of the government's counterterrorism efforts, as Special Advisor for Cyberspace Security.

This is not war games. Officials are worried that tech-savvy terrorists could do serious damage. In June, hackers were able to gain access to a California company that distributes power. Last October, pro-Israel and pro-Palestinian

VIRUS WATCH

Internet security company Riptech has an increasingly daunting task

been launched. But security experts fear that could change because vulnerable systems on the Net can be sabotaged hours by a determined hacker. "These people are very sophisticated in their ability

to plan, execute, and use the latest technology," says Elad Yoran, executive vice-president for Riptech Inc., an Internet security company.

The recent Nimda worm underscored the Net's vulnerability. On Sept. 18, a worm, a virus-like program that replicates itself, infected and shut down 100,000 computers within 24 hours. Future worms could have "sleeper" commands that would coordinate widespread activation of the virus with a conventional terrorist attack.

The events of September 11 have experts reevaluating previous notions about computer security. Now it's up to the cyber-cops and vigilant corporations to protect against the type of terrorism that comes at the speed of light—down a fiber-optic cable.

By Ira Sager in New York, with John Carey in Washington and Jim Kertter in San Mateo, Calif.

THE AFTERSHOCKS

hackers launched a cyber-skirmish. The attacks on Israel, dubbed a cyber-jihad by the pro-Palestinian hackers, escalated from defacing Web sites with images of children mutilated by war to shutting down such sites as the Bank of Israel's. "You more or less have to believe that any significant terrorist or criminal organization will have cybercapabilities," says Jeffrey Hunker, dean of the H. John Heinz III School of Public Policy and Management at Carnegie Mellon University and a former National Security Council member.

So far, no major cyber-attacks have

HOW SECURE IS THE INTERNET?

● A Sept. 12 GAO report found that 24 federal bodies, from Treasury to the Pentagon, have computer systems "riddled with weaknesses." Hackers could read or tamper with information.

● With the number of bugs and other problems in software products reaching an estimated 2,000 per year, tech organizations are at a loss to keep up with needed repairs.

● The Internet ties together more than 100 million computers, leaving hundreds of thousands of machines susceptible to a number of different cyber-attacks at any given moment.

● Many cyber-attacks are now so automated they spread across the globe within hours. And developing remedies is more difficult as attack technology grows more complex.

Data: CERT Coordination Center; General Accounting Office

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COMMENTARY

By Roger O. Crockett

HOW AN ACE MECHANIC COULD FIX MOTOROLA

It doesn't say "fix-it man" on Edward D. Breen's résumé, but it should. That would explain why Motorola Chief Executive Christopher B. Galvin named him president and chief operating officer on Oct. 3. The troubled electronics giant announced on Oct. 9 a \$1.4 billion loss on flat revenues of \$7.4 billion for the third quarter. A day later, the company added that it would post its first annual loss in 46 years. Such declines have investors crossing their fingers Breen can get Motorola Inc. humming again. "We're hopeful that Breen is going to be the right No.2," says David A. Katz, chief investment officer at Matrix Asset Advisors, which owns 530,000 shares.

Fixing Motorola won't be easy. Once the king of cell phones, it has fallen far behind Nokia Corp. Rivals are whipping its wireless infrastructure unit in the race to build next-generation networks, while others are grabbing share in chips. The troubles have sent the stock tumbling to \$17, down from \$60 in early 2000.

Breen will have to do plenty of housecleaning when he fully assumes those titles in January. Some units will likely go, and he'll have to focus on products customers want. Most important, he'll have to reinvigorate Motorola's ponderous culture, even as the demoralized company lays off 39,000.

Can Breen pull it off? His track record includes ample marketing flair, product smarts, and cost-cutting. As the CEO of General Instrument Corp. in the late 1990s, Breen built

the Horsham (Pa.) company into the nation's No. 1 maker of cable set-top boxes. He succeeded, in part, by getting customers to sign up for multi-year contracts, shutting out rivals. Then, after it merged with Motorola in Schaumburg, Ill., in January, 2000, Breen moved quickly to kill overlapping modems—impressing his new colleagues with an un-Motorola-like willingness to kill models that would not make money right away. "He can read a market and come up with winning people and products today—not three years out," says ABN Amro analyst Ken Leon. Here's how Breen can use those skills to buff up Motorola as a whole:

Wireless infrastructure. This \$7.8 billion business—21% of Motorola's sales—has floundered for years. Its

BREEN: A tested marketer and cost-cutter

market share has fallen from 22% in 1995, to 13% of this year's \$58 billion global market. In 2001, profits are expected to plummet from 2000's nearly \$1 billion to just \$130 million. Why? Largely because the unit lacks a switch, a type of computer that directs wireless calls through a network. So even though Motorola excels in making the gear that beams calls from a network, it doesn't have the all-in-one system that phone

carriers want. "As a stand-alone business, that unit has little chance of success," says Wojtek Uzdelewicz, an analyst at Bear, Stearns & Co.

Motorola has spent nearly two decades trying to find a strong switch partner. Ventures with DSC Communications, Nortel Networks, and Siemens failed because the companies' sales teams battled instead of cooperating. The time has come for Breen to spin-off or even sell the unit.

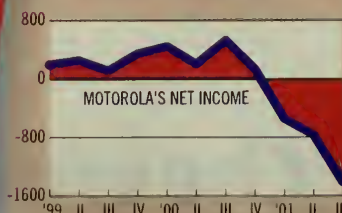
Semiconductors. For years, Wall Street has screamed for Motorola to exit the semiconductor business. Specializing in chips for the auto and communications sector, as well as for Motorola's phones, the unit boasts a measly 3.6% market share in an industry that demands economies of scale. And even during peak cycles, the \$7.9 billion business earned puny 8% margins. Selling it or spinning it off would also raise needed cash.

Cellular phones. Already, executives are working on a plan demanded by Galvin to slash the number of phones Motorola produces from 125 to a manageable 20 by 2003. But Breen should speed the moves up to build on the unit's nascent turnaround. Thanks to an earlier round of cost-cutting and the success of a batch of new models, cell phones brought in third-quarter revenues of \$2.7 billion, a bump up from the second quarter's \$2.5 billion.

Beyond each individual unit, Breen also faces challenges that cut across all of Motorola. He needs to get staffers—from Galvin on down—to speed product-development decisions and focus on fewer products—ones that customers really want. He'll also have to address two perennial problems: getting Motorola's engineering culture to concentrate on marketing and forcing more cooperation between its highly competitive units. If Breen can imbue Motorola with the savvy that got him to the president's chair, he may yet make his boss proud—and keep him employed.



HARD TIMES



▲ MILLIONS OF DOLLARS

Data: Bloomberg Financial Network

Crockett covers telecommunications from Chicago.



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COMPUTERS

HOW LOW CAN BIG BLUE GO?

IBM is gaining in the price war for the high-end server market

Last summer, as IBM was beefing up its line of high-end computer servers, General Manager Rod Adkins decided that employees needed a boost. Mugging for a company video, he pulled on a pair of boxing gloves and shiny trunks, climbed into a makeshift ring and, in a mock fight, promptly knocked out his opponent. The logo on the other guy's trunks: Sun Microsystems Inc.

Turns out that was just round one. As demand dries up, server makers are now hitting harder than ever on price, transforming this high-end business into a game of how low can you go. IBM is looking tough to beat. On Oct. 4, it unveiled its most powerful servers yet. They came out just two weeks after Sun started selling its brawniest box, the Starcat. While Sun's servers are in

some ways more powerful, the Regatta sells for about one-third the price, ranging from \$450,000 to \$1.7 million per box. "This is a Sun-IBM shoot-out," says Jonathan Eunice of research firm Illuminata Inc.

IBM's assault couldn't have come at a worse time for Sun, the leader in the \$19 billion global market for Unix servers. Spending on big-ticket computer equipment continues to suffer as anxiety over the terrorist attacks and the U.S. response compounds the already jittery tech market. Sun had to warn Wall Street on Oct. 5 that its fiscal first-quarter loss will grow to at least \$170 million, and revenue will fall 30% from last year as dot-com and telecom business evaporates. That forced Sun CEO Scott G. McNealy to cut 9% of his workforce, ending his quest to



BAD TIMING FOR SUN

Plants were already suffering layoffs when IBM's cheap new server hit the market

weather the downturn without layoffs

IBM's latest salvo in the server wars is also bad news for its other competitors. The No. 3 and 4 players in the market, Hewlett-Packard Co. and Com

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q Computer Corp., already weakened, e ill-equipped to fight a price war. As ey try to sell shareholders on their oposed merger, they are fighting to ung on to customers who fear the al's distractions will translate into asy service.

The real fight, though, is between M and Sun. Three years ago, IBM rezed that Sun was trouncing it in high-d server sales. So it focused on lower

prices and improved technology. By 2000, IBM was offering discounts of more than 50%, sometimes throwing in free gear or services. The strategy worked. IBM raised its market share to 20% in this year's second quarter, up from 15% last year, according to UBS Warburg.

PRICE LURE. With only 1% of revenue and 4% of operating profits from high-end Unix servers, IBM can afford to dramatically slash hardware prices. That helps lure in high-margin services and software business. Sun, by contrast, depends on its most expensive servers for 10% of revenue and 25% of operating profits, says Toni Sacconaghi Jr., an analyst with Sanford C. Bernstein & Co. The lower IBM prices, combined with new added features, means savings "in the millions," says Regatta customer Joe Giacometti, who buys technology for grocery giant Ahold USA Inc.

Sun is hardly taking it lying down. It is about to release lower-priced servers to appeal to cash-strapped customers. And when spending on tech gear picks up, Sun executives also believe the rewards of

continued investment in research and development will boost its lead on IBM. Says McNealy: "If they don't get us this year, they won't get us."

With Unix server revenue projected to fall 9% this year, the real game for both IBM and Sun may simply be snatching customers from HP and Compaq. Together, HP and Compaq own 27% of the market, but questions about their proposed marriage are causing many customers to consider switching.

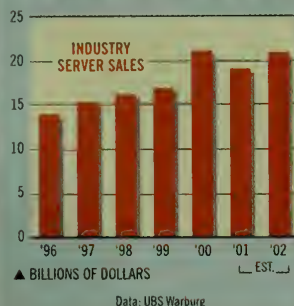
Other long-term customers are willing

to give HP and Compaq the benefit of the doubt for now. "At this point, focus is everything," says R. Craig Murphy, chief technology officer at airline-reservations giant Sabre Inc., which agreed this summer to move to Compaq servers in a long-term contract. But as the IBM juggernaut chugs along, getting and keeping more cus-

tomers like Murphy won't be easy for any of Big Blue's rivals.

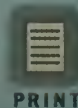
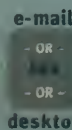
By Andrew Park in Dallas, with Peter Burrows in San Mateo, Calif., and Spencer E. Ante in New York

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AS GLOBAL CROSSING SINKS, GARY WINNICK STAYS DRY

He sold shares regularly as the business he ran deteriorated

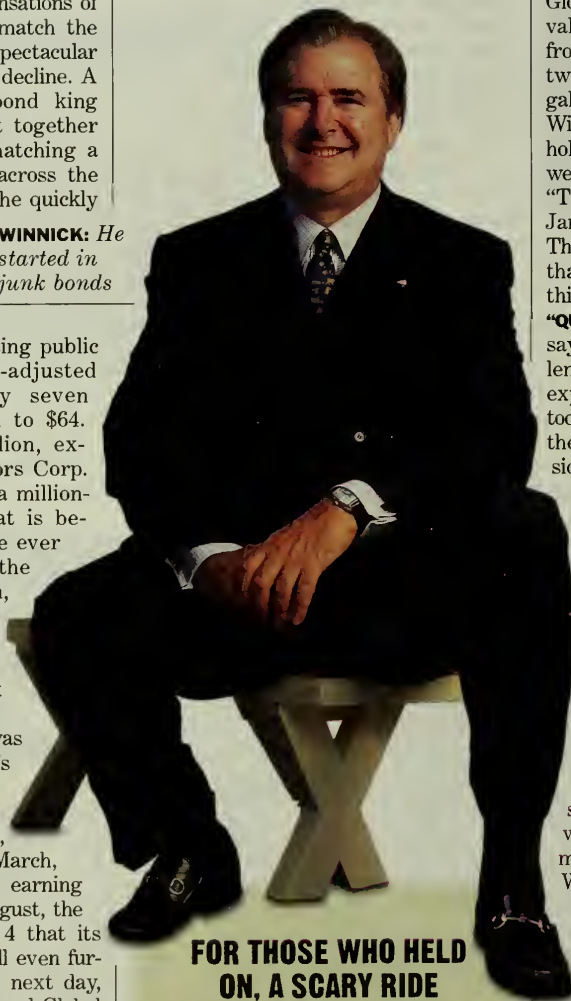
Of all the overnight tech sensations of the late 1990s, few can match the story of Gary Winnick's spectacular rise and equally breathtaking decline. A former associate of junk bond king Michael Milken, Winnick put together Global Crossing Ltd. after hatching a plan to lay fiber-optic cable across the Atlantic in 1997. From there, he quickly built an international telecommunications business delivering phone and data services to Europe, Asia, and Latin America.

WINNICK: *He started in junk bonds*

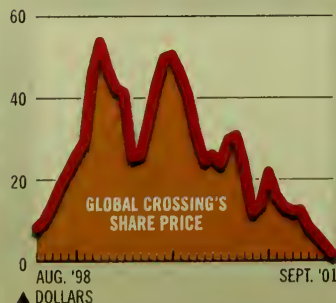
Winnick took Global Crossing public in August, 1998, at a split-adjusted \$9.50 a share, and barely seven months later, it had soared to \$64. Its market cap, at \$47 billion, exceeded that of General Motors Corp. Winnick's secretary became a millionaire, and Winnick paid what is believed to be the highest price ever for a single-family home in the U.S., more than \$60 million, for an estate in Los Angeles' Bel Air neighborhood. "Money's no fun unless you spread it around," Winnick told *BusinessWeek* last year.

OFF THE BIG BOARD. That was then. But Global Crossing's stock, like that of many other once high-flying tech and telecommunications companies, has slid precipitously since March, 2000. And, after reducing its earning forecasts sharply this past August, the company announced on Oct. 4 that its revenues and cash flow will fall even further below expectations. The next day, Standard & Poor's Corp. removed Global Crossing from the S&P 500-stock index; its shares now sell for just 50¢. Bond-rating agencies have put the company's already junk-rated debt on watch for further downgrades.

Awful as Global Crossing has been for investors lately, Winnick, who serves as company chairman, hasn't made out too badly. That's because he has long been a prodigious seller of Global Crossing stock. In September, 2000, a spokesperson confirmed that Winnick had sold some \$600 million of Global Crossing stock since the company's initial public of-



FOR THOSE WHO HELD ON, A SCARY RIDE



Data: Bloomberg Financial Markets

fering. Winnick received the majority of his shares as result of his \$15 million founding investment in the company. At this past May, Pacific Capital Group, an investment firm controlled by Winnick, generated an additional \$123 million in proceeds through a complicated financial arrangement known as a collar.

Certainly Winnick has the right to sell his shares. And he hasn't emerged from Global Crossing's plunge unscathed. The value of his stake, now 8.9%, has shrunk from \$6 billion to \$30 million in the past two years. But it has been particularly galling to many company watchers that Winnick regularly cashed in his personal holdings even when the company's losses were mounting and its stock was tanking. "The stock sales bothered me," says James Linnehan, a telecom analyst at Thomas Weisel Partners. "Looking back, that was one step in the whole doom this."

"QUITE DISCONCERTING." Winnick's critics say the chairman has compounded problems inherent in an overly aggressive expansion strategy by burning through too many senior executives. John Legere, the head of Global Crossing's Asia subsidiary, was named CEO on Oct. 4—the company's fifth chief executive in its four-year history. "It's quite disconcerting," says Patrick Comack, a telecom analyst at Guzman & Co. "Winnick is like the George Steinbrenner of the telecom industry—except he hasn't won the World Series."

A dealmaker since his days with Milken, Winnick has also made some bad strategic moves at Global Crossing. Analysts say that after failing to win control of local telephone operations in the West in 1999, Winnick should have sought another merger partner that would have given Global Crossing a more stable base of customers. Instead, Winnick continued to plow money into finishing Global Crossing's undersea cable network even as the value of such networks sank in the public market.

New CEO Legere says he is confident that Global Crossing will weather the current storm just fine. He is taking steps to reduce the company's capital spending, sell off nonstrategic assets, and reacquire the 40% of Global Crossing's Asia operations that Winnick sold to the public last year. "There's no network like the one we built," says Legere. "The market is coming back." But it may never come back enough to satisfy Gary Winnick's many unhappy shareholders.

By Christopher Palmeri and Art Weintraub in Los Angeles



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EDITED BY MONICA ROMAN

MICROSOFT'S FOES SEE HOPE IN EUROPE

AS MICROSOFT'S COMPETITORS grow concerned the U.S. Justice Dept. will go easy on the software giant in its antitrust suit, their attention has shifted to the European Union. The latest draft of the EU's statement of objections against Microsoft's alleged monopolistic practices is giving them reason to cheer. Much of the 70-page statement, distributed to several rivals in August and detailed by *The Wall Street Journal* on Oct. 10, deals with the ways Microsoft makes it difficult for competitors to run applications that work well with its Windows operating system. That suggests the Europeans may force Microsoft to disclose more information about Windows to competitors.

To make its case in Europe, the company is relying on affidavits from companies

and organizations that use its software. Microsoft denies charges that those who signed the affidavits weren't aware they would be used in such a manner, a point the company will include in its response to the EU statement next month. Microsoft "is open to looking for ways to resolve the [EU's] concerns," says the company's European general counsel, John Frank.

In the U.S., Microsoft lost its last bid to overturn the June 8, 2000, ruling that it violated the Sherman Antitrust Act. On Oct. 9, the U.S. Supreme Court rejected Microsoft's argument that the ruling was tainted by the ethical lapses of the case's then-presiding judge, Thomas Penfield Jackson. The court's decision turns up the heat on Microsoft to reach a settlement. The company has been meeting with the Justice Dept. and state attorneys general toward this end. If they can't reach a deal, federal judge Colleen Kollar-Kotelly is scheduled to appoint a mediator on Oct. 12.

CLOSING BELL

HEALTHY RISK

Terrorism fears are fueling investor interest in New York-based risk consultant Kroll. Since September 11, its share price has surged 84%, to \$13.25 on Oct. 10. Kroll expects its security-services revenues to double this year, thanks to demand for executive protection, building security, crisis management, threat assessment, and political-risk data.



ENRON RECHARGES ITS UTILITY SALE

ENRON HOPES THE SECOND time is a charm in its attempt to unload its Portland General Electric unit. On Oct. 8, the Houston energy-trading giant agreed to sell the electric utility to Northwest Natural Gas for \$3 billion. Enron bought Portland General five years ago for \$3.2 billion in an effort to break into deregulating power markets, a strategy that it has since backed away from. It earlier agreed to sell Portland General to Sierra Pacific Resources for \$3.1 billion, but the deal fell apart in April. Some analysts have blamed Enron's falling stock price partly on investments outside its core natural-gas trading and wholesale electricity sales businesses.

HEADLINER: NICHOLAS SCHEELE

FIRST, BUILD A BETTER CAR

FORD MOTOR'S NEW NORTH American chief, Nicholas Scheele, is setting a fresh agenda—one that looks like an about-face from the strategy his boss, CEO Jacques Nasser, has been pushing since 1999. "We are going back to basics," Scheele told employees recently. "Some actions that we've taken in the past few years maybe distracted us and contributed to a deterioration in quality." Ford execs insist Nasser's basic mission—to make Ford a consumer-driven company—won't change. But Nasser-led moves such as buying dealerships



and other auto-related businesses will take a backseat to Scheele's focus on the job of manufacturing quality vehicles. Ford's problems have been building all year but with cash dwindling to about \$3 billion, from \$15 billion in mid-2000, there's a rising sense of urgency. The auto maker has already cut executive bonuses and is eliminating 5,000 white-collar jobs. Ford is halving its quarterly dividend to 15¢ per share, saving about \$1 billion a year. Expect more drastic actions by yearend.

Joann Mulvey

MORE COMPETITION IS IN THE CARDS

SIXTEEN MONTHS AFTER IT started, the Justice Dept.'s suit against Visa and MasterCard is over—for now. U.S. District Court Judge Barbara Jones said on Oct. 9 that the two companies, which control 75% of all credit cards, can't prohibit banks from issuing competing cards from American Express and Discover. Justice fell short of its original intentions, though. It had hoped to prove that MasterCard and Visa had a duopoly, which the court denied. Mastercard said it will appeal the first ruling.

POLAROID COULD BE GONE IN AN INSTANT

POLAROID'S DAYS ARE NUMBERED. The instant-photography giant could file for Chapter 11 bankruptcy protection as early as Oct. 11, after po-

tential buyers balked at taking on the company's rapidly deteriorating film business and its \$900 million in interest debt. Sources say that as many as 12 suits, including large Japanese consumer-products companies, considered participating in so-called prepackaged bankruptcy plan. But creditors insisted, pushing instead for straight sale. One likely scenario: Cambridge (Mass.) based Polaroid could be sold in parts, with its digital and instant-film businesses going to different buyers.

ET CETERA...

- J.M. Smucker will buy Jif peanut butter and Crisco cooking oils for \$670 million
- Rupert Murdoch's talks to buy GM unit DirectTV are moving ahead, sources say
- AT&T will purchase the 2nd of wireless carrier TeleCom that it doesn't already own

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EDITED BY RICHARD S. DUNHAM

WARTIME POLITICS: THE DOWNSIDE FOR DEMOCRATS

On Sept. 10, Democrats were excited about their chances of sweeping Congress in 2002. They were lining up a sterling cast of recruits, and Senate Majority Leader Tom Daschle (D-S.D.) was pounding out a popular agenda that included education, health care, and that Old Reliable of Democratic issues, Social Security. But that was then.

Now Democrats have temporarily lost Social Security as an issue, and a number of their best recruits are going AWOL. Meantime, Republicans have the upper hand on the top issues of the moment: defense, foreign policy, and law enforcement. Indeed, an Oct. 5-6 Gallup Poll gives the GOP a 56% to 21% edge over Democrats when it comes to handling America's No. 1 concern: terrorism.

In the all-important candidate-recruitment game, several GOP incumbents who had been expected to retire—including Tennessee Senator Fred Thompson and Kansas Representative Jerry Moran—instead have announced plans to seek reelection. Now, Thompson and Moran are prohibitive favorites.

PATRIOTIC RETREATS. The dismal news for the Dems doesn't stop there. In Oregon, Governor John A. Kitzhaber, who had been leading GOP Senator Gordon H. Smith in the polls, opted out of the race. Two other top Democratic prospects—retired three-star General Claudia J. Kennedy of Virginia and former Agriculture Secretary Dan Glickman of Kansas—bowed out, saying the war against terrorism played a role in their decisions. Kennedy didn't feel comfortable raising campaign funds amid a military crisis, and Glickman saw his chances of winning in a Republican state cut substantially. In Florida, former ambassador Pete Peterson, a POW during Vietnam, said the need for national unity led him to drop his bid for the Democratic nomination for governor. On the plus side, the

crisis atmosphere helped propel Erskine B. Bowles, a respected Charlotte venture capitalist and former Chief of Staff to President Clinton, into a possible matchup with Elizabeth Dole for the Senate seat being vacated by Jesse Helms (R-N.C.).

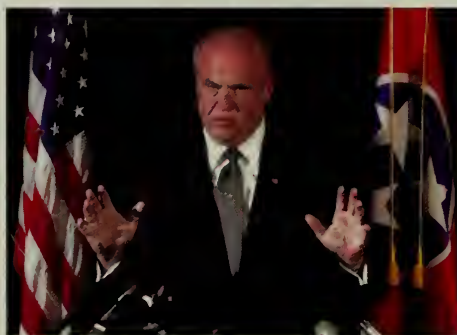
The new realities have prompted both parties to shift strategies. Now there's a premium on candidates with military or foreign policy experience. That's why the Dems' loss of Kennedy—once the highest-ranking woman in the military—was so disheartening. Still on the wish list: Arkansas Democrat are hoping to persuade retired General K. Wesley Clark, the former NATO commander, to run for governor in 2002.

Dems are left hoping a crisis atmosphere isn't necessarily a boon to their party in the White House. In 1942, for example, the GOP won 55 Democratic House seats and 9 Senate spots in the months after Pearl Harbor. And made strides after World War II by recruiting vets such as Richard Nixon to do battle with communism. Its last effort to woo ex-soldiers—when Newt Gingrich tried to enlist 80 Desert Storm and Vietnam vets after the victory over Iraq—fizzled as gusto for war shifted to recession anxiety. Con-

cedes Senator Charles E. Grassley (R-Iowa): "I'm not sure terrorism helps the Republicans as much as anticommunism."

Democrats are clinging to other glimmers of hope, too. Despite the President's popularity topping 80%, the Gallup Poll gave the GOP just a one-point edge when voters were asked which party they'd like to see control Congress. To turn things around, Dems are counting on voters shifting attention from war to recession. That could still happen. But without compelling new candidates, Democratic hopes no seem more likely to be dashed.

By Lorraine Woelke



STILL IN: The GOP's Thompson won't retire

CAPITAL WRAPUP

RUDY FOR THE CIA?

► There's no vacancy yet, but one name is being talked about as a successor to CIA Director George J. Tenet: New York Mayor Rudolph Giuliani. If anyone is held accountable for the intelligence failure that permitted the September 11 terrorist attacks, Tenet is a likely fall guy. The White House's choice of the hard-charging Giuliani, a former prosecutor whose term ends in January, would send a clear message: America is determined to nail the culprits behind the attacks.

GOOD NEWS, BAD NEWS

► The number of Americans without health insurance has dropped from 39.3 million in 1999 to 38.7 million in 2000, says the Census Bureau. Unfortunately, nobody expects the trend to last. With the economy slowing and health-care costs soaring, the ranks of the uninsured will swell again, says the Health Insurance Assn. S. Jackson Faris, president of the National Federation of Independent Business, says the situation is "like looking at photos from a party that's been over for months."

LIBERAL LANDSLIDE

► Is the Democratic Party continuing its move toward the center begun during the Clinton years? Don't count on it. Liberals won a big battle on Oct. 1 when California Representative Nancy Pelosi easily defeated moderate Steny Hoyer of Maryland for the No. 2 Democratic House leadership spot. Pelosi replaces House Minority Whip David Bonior, who will run for governor of Michigan. Pelosi, a vocal critic of tax cuts and trade liberalization, will be the highest-ranking woman in Congress.

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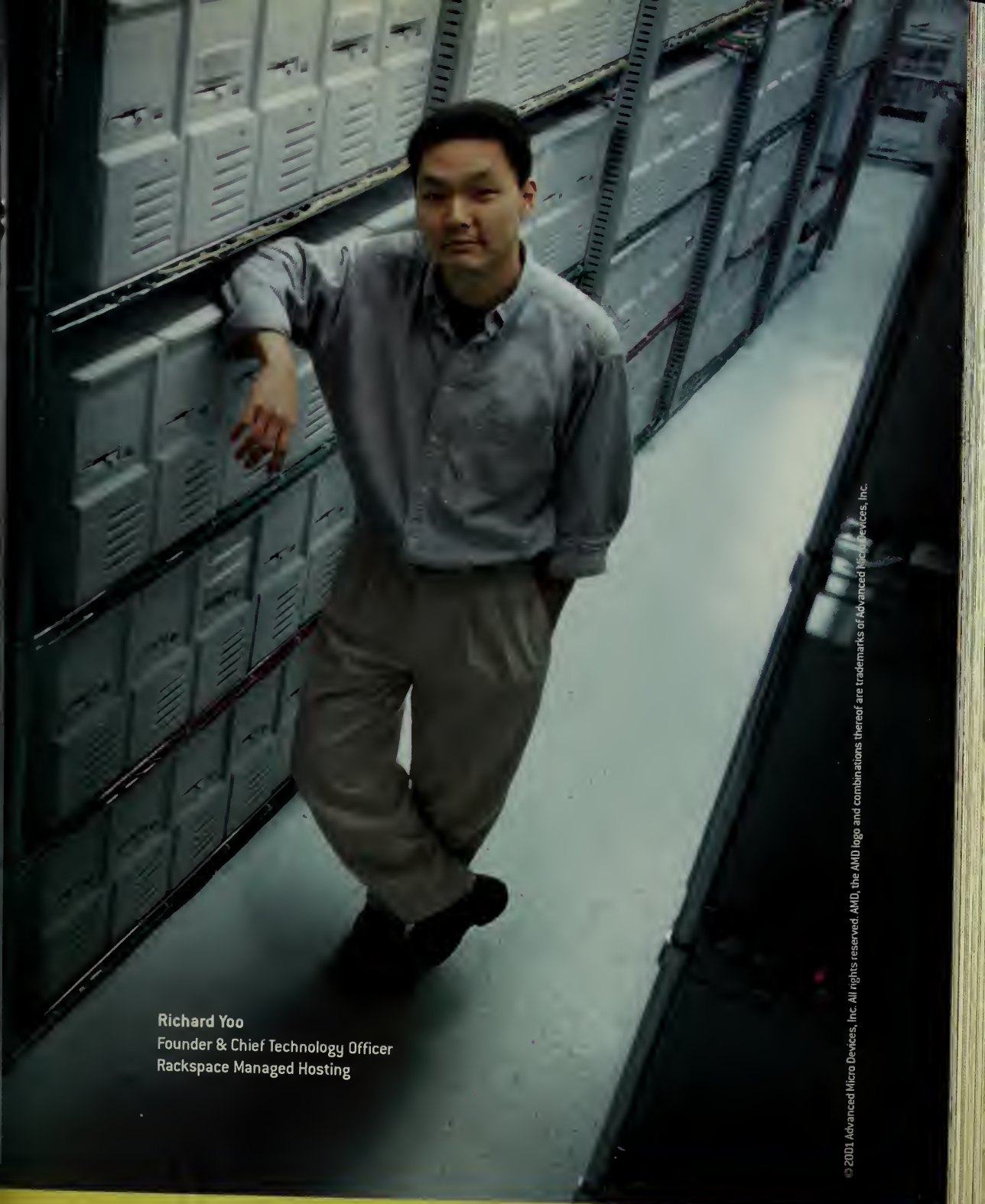
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A man, Richard Yoo, is standing in a server room. He is leaning against a rack of server units. He is wearing a light blue button-down shirt and khaki pants. The server racks are filled with various electronic components and cables. The lighting is somewhat dim, typical of a server room.

Richard Yoo
Founder & Chief Technology Officer
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EDITED BY OTIS PORT

SEEKING AN ANTHRAX CURE IN YOUR SPICE GARDEN

OREGANO MAY BE A LOT MORE than just a tasty herb you sprinkle on pizza and spaghetti. It could turn into the next wonder drug. The herb was celebrated by the ancient Greeks as an antidote for hemlock poisoning. But the latest research suggests it may clobber fungi and bacteria—possibly including the virulent anthrax bug, a potential bioterrorist weapon.

In recent tests on mice, Dr. Harry G. Preuss of Georgetown University Medical Center found that oregano-oil extract is just as effective as the most potent antibiotic in combating staphylococcus bacteria, which can cause deadly infections and is becoming increasingly resistant to many antibiotics. Similarly, oregano oil wipes out a fungus called *Candida albicans*, which causes diaper rash and other ailments.

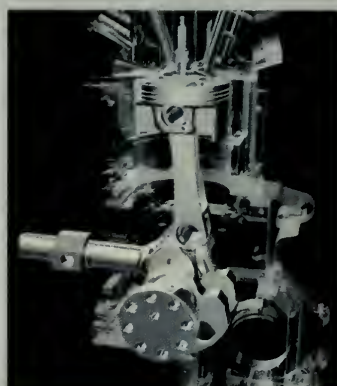
As for anthrax, animal tests haven't started yet, but Dr. Cass Ingram of North American Herb & Spice Co., who collaborates with Preuss, says oregano oil has proved effective in test-tube experiments. So it looks poised to make a big-time leap from the spice cabinet to the medicine cabinet. *Pallavi Gogoi*

A DESIGN TWEAK FOR CLEANER ENGINES

BRITISH ENGINEER Joseph Ehrlich has been tinkering with racing engines for motorcycles and Formula One speedsters for six decades. It was 11 years ago that he hit on an idea for leveraging—literally—better performance from engines. On Oct. 2, his concept was unveiled in London by Mayflower Corp., a British bus- and truckmaker that funded Ehrlich's work and dreams of fat royalties from licensing the design for almost any engine, from chainsaws to cars.

Ehrlich's lever is a pivoting arm that sticks out from the side of the crankshaft, one for each piston. Attaching piston rods to these levers instead of directly to the crankshaft changes how the pistons move. They spend a bit longer at the top of their strokes, which keeps fuel compressed so it burns more completely—cutting emissions in half, Mayflower reports.

The levers also help Ehrlich's e3 engine generate more thrust. When a cylinder fires, the piston rod is at an angle and can immediately turn the crankshaft via the cam at the end of the pivoting arm. In ordinary engines, the piston rod is vertical when the fuel ignites, so the initial burst of energy doesn't help turn the crankshaft. Eliminating that momentary waste, Mayflower says, means the engine can get better mileage with no sacrifice in performance. But don't look for Ehrlich's wonder engine to show up in cars anytime soon. Detroit will no doubt put it through grueling tests that will take several years. ■



EHRlich's e3 ENGINE: *The key is a lever (left) that projects from a collar around the crankshaft (lower right)*

COMING SOON: JETS THAT LAND THEMSELVES

MOST COMMERCIAL JETS ARE so automated they can practically land themselves. In the wake of the September 11 attacks, many pilots and security experts hope to improve autopilot systems so that jacked planes could land without pilot assistance—or jacker interference.

Raytheon Co. has shown that there are benefits in using global-positioning system (GPS) technology for autopilot landings instead of the current instrument landing system (ILS). Project Manager Bruce A. Solomon says it requires only one "beacon" for an entire airport, not multiple ILS transmitters at the end of each runway. If smaller airports purchased such systems, which cost less than ILS, they might avoid some private-plane accidents.

The Raytheon system has other advantages. It means planes can land on any runway at a GPS-equipped airport, instead of only at runways with ILS beacons. Planes could also land taking a curved approach rather than a straight approach down a specific runway glides path. This might help reduce noise over residential neighborhoods. In addition, the technology is fully standardized, so commercial and military planes can take advantage of the same equipment.

How precise is a GPS landing? Accurate enough to put a jet fighter onto the deck of an aircraft carrier, a feat that was performed early this year. Solomon says Raytheon's system isn't quite hands-free yet. A pilot still has to handle one task: selecting a runway code. In this procedure could be automated as well. The Force is funding development of Raytheon's system. *Geoffrey Smith*

HOW SEA TURTLES STEER

FROM THE FIRST TIME THEY DIP THEIR TINY green feet into Florida's surf, young loggerhead sea turtles are master navigators. They migrate across the North Atlantic and pass the coasts of France and Spain before returning home. And they avoid a dangerous current that could carry them into waters where they probably wouldn't survive.

To find out how they do it, Kenneth J. Lohmann, a University of North Carolina biologist, built on his earlier research

showing that the turtles could detect the angle and intensity of magnetic fields. He put baby loggerheads into a pool wearing little blue bathing suits tethered to an electronic tracking unit. Then he simulated the

magnetic conditions that exist at each of several key points along the migration route. In the Oct. 12 issue of *Science*, he reports that each time the field was switched, the loggerheads' built-in compasses prompted them to shift the direction in which they swam, turning the right way to keep them bound for safe waters.

Paul Raeburn



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EXECUTIVE SUITE

SELLING FURNITURE AND TOLERANCE



CEO Farooq Kathwari has revitalized Ethan Allen, while leading a campaign to bring peace to Kashmir

Grief, comfort, gratitude, patriotism. That was the language of most chief executives' messages in newspapers around the country after the violence of Sept. 11. But M. Farooq Kathwari, the head of furniture retailer Ethan Allen Interiors Inc., a Muslim who left Kashmir some 35 years ago and now an American citizen trying to bring peace to that troubled place,

wrote of something else. Deep sadness, yes. But also of the need to "foster unity among people of different faiths." As community leaders have stated in the days since the Twin Towers fell, Kathwari says: "The terrorists win if the search for justice turns to vengeance."

Kathwari, 57, knows something of how grief and anger work on people. His eldest son was killed in Afghanistan in 1992: Imran, a 19-year-old college student born and raised in America, was drawn there by romantic notions of the fight against the Russians (and by that time, the regime they backed), says Kathwari. Imran went despite the family's opposition. He died in a mortar at-

tack, in one of the last battles for the capital, Kabul. "My son is lying in rubble in Afghanistan," Kathwari says.

A death like that could make a parent bitter for life. And Kathwari was for a while. But eventually he decided to get involved, not in Afghanistan but in Kashmir, as a diplomat of sorts. At least 35,000 Kashmiris have died or disappeared since 1989, when their renewed call for more autonomy, if not independence, from India, sparked a rebellion that Pakistan supports. Kathwari, once a student activist in Kashmir, brought together a group of predominantly American politicians, academics, and former diplomats in 1996 to suggest ways to end the civil strife. Kathwari, talking publicly about his work there for the first time, says: "I wanted to try to save parents from the agony of losing a child. And Kashmir helped me maintain perspective."

What makes Kathwari's experience so interesting is the way in which it has influenced his leadership at Ethan Allen, that most traditional of American retail icons. He's as demanding as a CEO. But colleagues also to

KATHWARI REARRANGES ETHAN ALLEN

- ▶ Led a management buyout in 1989 that gave him more operational control
- ▶ Made its furniture more fashionable, now offering new collections more frequently
- ▶ Redesigned its 300-plus stores and relocated half to prime retail property

KATHWARI IN THE COMPANY'S DANBURY (CONN.) SHOWROOM

about his sense of justice and humility. As Sandra Lamenza, vice-president and general manager of the retail division, puts it: "Ego is not tolerated. You can throw power around."

Kathwari, who grew up in a privileged, politically active family, left Kashmir in 1965 to obtain an MBA at New York University. After a few years on Wall Street, he began importing handicrafts from Kashmir. In 1980, Kathwari sold his company to Ethan Allen, an early client, and five years later he was promoted to president.

Since then he has changed almost everything about Ethan Allen: the furniture, the design of its 300-plus stores,

the garage door closes, you think to yourself:
Phew, that was fun."

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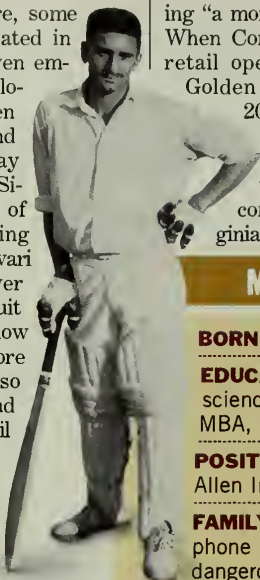
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relationship with dealers, and the senior management, almost all of whom retired between 1988 and 1990. Ethan Allen used to sell traditional furniture, some of which hadn't been updated in 40 years, in stores that even employees say looked like colonial museums. "Ethan Allen was a trusted, dusty brand in danger of going the way of the Oldsmobile," says Simon Williams, chairman of brand consultant Sterling Group in New York. Kathwari and his designers made over its Valley Forge look to suit modern tastes and they now launch new collections more frequently. They have also remodeled most stores and relocated half to prime retail space.

At the same time, Kath-

A CEO-TO-BE:

Playing cricket in 1964



wari took on the independent dealers who sold most of Ethan Allen's furniture. Breaking with industry protocol, he told them to sell only the company's merchandise at one price to be set in the Danbury (Conn.) headquarters. He also required them all to buy the furniture at the same price; before, the bigger dealers received a discount. Several of them confronted Kathwari in 1986, saying: "Do you think you are Robin Hood? You're giving to smaller dealers at [our] expense." To Kathwari it was an issue of fairness, and that was that. Two dealers walked out.

A MESSAGE. Now the transformation is almost complete. To fend off a hostile bid in 1989, Kathwari led a \$350 million buyout; that gave him a 10% stake in the company and more operational control. Kathwari took Ethan Allen public again in 1993. At most stores, sales have tripled since 1985, and the company's profit margins are the highest of any furniture manufacturer. But of course, no business is immune to the slowing economy and the likelihood of protracted military action. Profits for the fiscal year that ended on June 30 were \$84 million, down 7% from a year ago. Sales were \$904 million, up 5.6%. As late as June the stock price was holding up well, at about \$38. Now it's trading around \$30. To reduce costs, Kathwari closed three U.S. factories this year and he is moving some production to Southeast Asia. He still expects sales to grow 5% in 2001. Though that may be optimistic these days, the compa-

ny does have a strong enough balance sheet to weather a recession.

Kathwari talks often about establishing "a moral precedent" at Ethan Allen. When Corey Whitely, vice-president of retail operations, won the company's Golden Kite achievement award in 2000, Kathwari said he should think of it as recognition that he fulfilled his responsibilities with modesty. And when the company bought a plant in Virginia ten months ago, he told Char-

M. FAROOQ KATHWARI

BORN Aug. 16, 1944, Srinagar, Kashmir

EDUCATION BA, literature and political science, Kashmir University, 1965; MBA, New York University, 1968

POSITION Chairman and CEO, Ethan Allen Interiors Inc. since 1988.

FAMILY Married wife, Farida, over the phone in 1968 because it was too dangerous to return to Kashmir; they have a son and a daughter. Their eldest son was killed in Afghanistan in 1992.

ON VACATION Kathwari climbs mountains. In 1993, he joined a group organized by Gary Wendt, then head of GE Capital, that ascended Mt. Kilimanjaro.

OUT OF THE OFFICE He is trying to bring peace to his troubled homeland. Five years ago, he founded the Kashmir Study Group of politicians and academics, which has presented peace proposals to India and Pakistan.

AFTER SEPT. 11 Kathwari put a full-page notice in *The New York Times* and *The Washington Post* calling on America's leaders to continue fostering unity among people of all faiths.

lie Farfaglia, vice-president of human resources, to recognize the employees' service with the old company when determining benefits. Kathwari also speaks of religious tolerance, when speaking of it seems appropriate. At a Christmas dinner he hosted, he read from the Koran about the birth of Jesus. After Sept. 11, the staff agreed Ethan Allen should put a public message in a few newspapers. "They know of my loss. They know I believe injustice is a sin," he says. Kathwari wrote the note himself.

Kathwari is intimately involved, some would say overly, in running the company. That doesn't work to everyone's benefit. After years of operating without a chief financial officer—the company

has a controller—Kathwari decided last year to hire William Beisswanger from Ernst & Young LLP. He left after nine months. Beisswanger would only say that "Farooq is very hands-on. I didn't think it was the right place for me. Kathwari has since hired someone else."

Any difficulties with the turnaround pale alongside Kathwari's efforts to bring peace to Kashmir. The Kashmir Study Group is an independent effort, initially welcomed by no one and still criticized by some as out of touch. But over the past

five years, Kathwari has largely persuaded Indian and Pakistani officials that he is serious, fair, and worth their time. "He and his project are highly respected by both sides as well as the U.S. government," says Bush Administration official.

The group's report, released early 2000, offers a supple approach to sovereignty, giving Kashmiris a majority of whom are Muslim) the right to rule themselves within India or Pakistan. That is a controversial notion among Indians who want to retain control, and some of the view Kathwari with suspicion. "They've asked the leaders to imagine a settlement that's fair to both. It's very helpful just to get people thinking about that," says Frank Wisner, a former ambassador to India who is now a director at Ethan Allen. Last year Kathwari met with Pakistan's ruler, President Pervez

Musharraf, and Indian officials close to Prime Minister Atal Bihari Vajpayee; he was one of many urging them to talk. The two met in the Indian city of Agra in July and are considering another summit. The violence continues: A car bomb exploded near the state legislature Oct.

killing at least 40 people. Now, though there may be more pressure to bring peace to Kashmir, says Kathwari, because then "those fighting jihad the would lose an important base."

Kathwari insists that his work in Kashmir didn't distract him from Ethan Allen, and the board doesn't seem worried. "It helps give him a sense of value beyond the furniture business," says Edward H. Meyer, a director and head of Grey Global Group Inc., an advertising agency in New York. Who can argue with that?

By Susan Berfield in New York, with bureau reports



CRM and the Internet

Managing Collaborative Relationship Networks
for Strategic Advantage



Relationships: Priceless Assets in the Customer Economy

Customers have more power than ever before. Enterprises must compete based on relationships, not just the basic products and services customers have come to expect. In addition to traditional direct channels, businesses are moving to the Web and also working with channels and alliance partners to meet customer needs. Industry leaders are proactively managing these networks of relationships to build loyal and profitable end customer relationships.

Welcome to the brave new world of the Customer Economy. Studying the trends over the past two years, it's clear that business is moving inexorably toward more collaborative models driven by, you guessed it, the Internet. To succeed in the future, companies will need to define their relationship network opportunities, decide what information should be shared, and invest in the systems needed to make multi-enterprise integration work.

Customer Relationship Management (CRM) is a business strategy to get, grow, and retain the right customers, leading to long-term profitability. Thanks to the Web-accelerated power shift to customers, CRM is essential to create a sustainable competitive advantage based on relationships, not just products.

The CRM software industry is growing and changing rapidly, reflecting the strong influence of e-business technologies. Boston-based AMR Research pegs the "Customer Management Market"—which includes software for marketing, selling, support/service, and sell-side e-commerce—to grow at a 29 percent per year pace, from \$14.1 billion in 2001 to \$37.8 billion in 2005. Factoring in integration costs, total world-

wide CRM investments could exceed \$75 billion in 2005.

In an August 2001 CRMGuru.com webcast, panelist Rod Johnson, AMR Research's service director for customer management strategies, said that CRM is in its "Third Coming." Draw the lines where you will, his point is that not long ago everyone thought CRM meant a certain set of customer-facing tools. Now, we're realizing it encompasses how to drive a campaign, how to manage customer contact, and how well you provide field service. It includes the Internet, partners and traditional e-commerce capabilities.

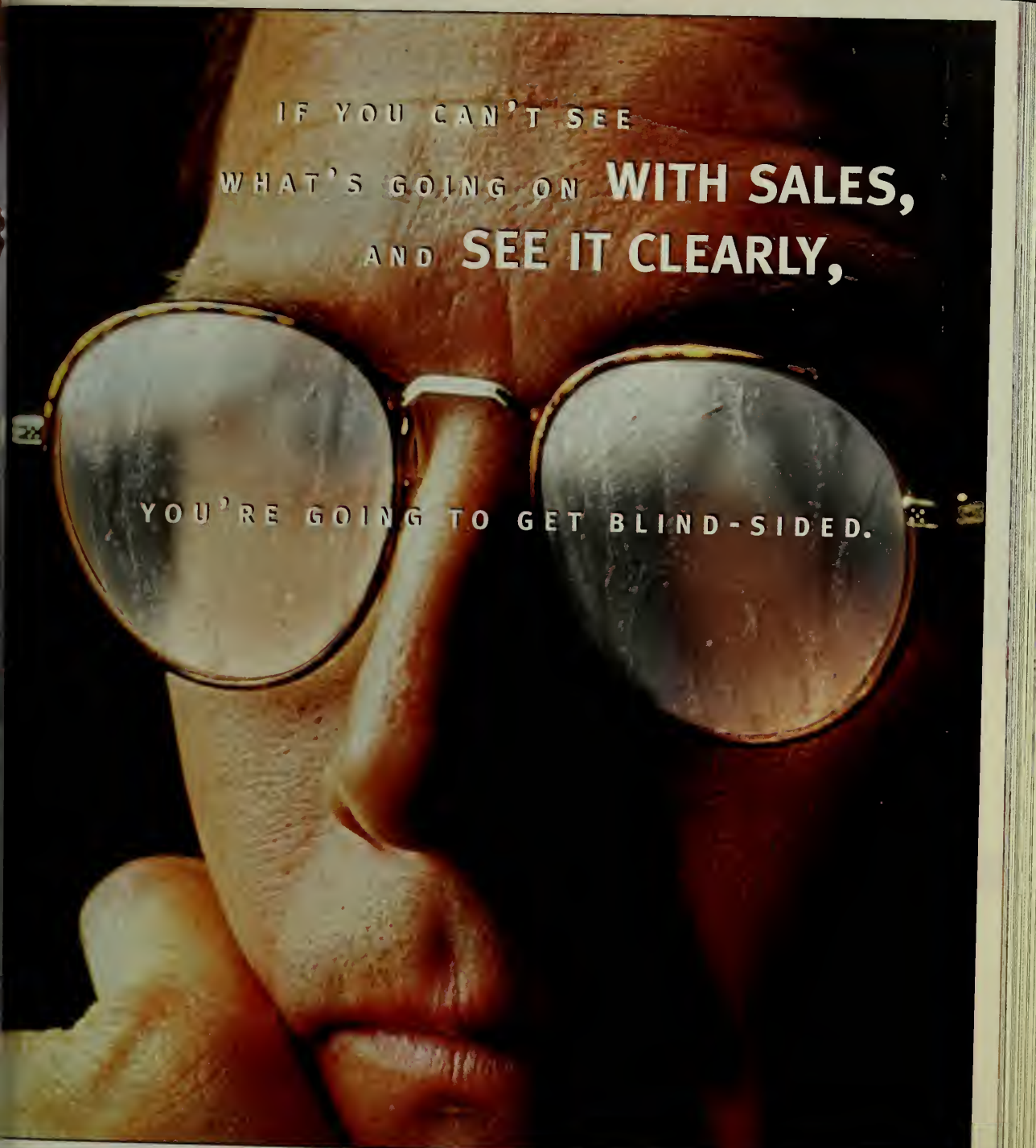


In the future, entire CRM application suites will be Web based, not just self-service tools. Portals will become increasingly critical technology, and integration technology will allow more connections and analytics to be embedded in business intelligence.

In other words, CRM is shedding its old skin and growing into something that reflects the networked environment in which we all live and work. This special section will look at how business is moving toward more collaborative models, and how CRM will both change and direct that evolution. Topics will include:

- Impact and opportunities of the Internet on the "Customer Chain" including value-added intermediaries
- The evolution of CRM from a focus on internal efficiency to more effective external relationships
- Why multi-channel CRM must evolve to integrated relationship networks
- How to make collaboration with partners and customers deliver real business benefits
- The critical role of Partner Relationship Management in the emerging Collaborative Age
- Trends and directions for CRM and Collaborative Relationship Networks

Today, there is more opportunity than ever to relate to customers quickly and efficiently. There's never been a better time to be a customer—and there's never been more opportunity for businesses to gain or lose customers. Hang on for the ride.



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CRM and the Internet

Impact of the Internet on the Customer Chain

Let's get one thing straight: The Internet doesn't change everything. Yes, it provides the opportunity for profound changes in the way companies and people can work, collaborate and interact with each other. Yes, it's enabling business-to-business collaboration to work better than ever before. But it's not changing the way you brush your teeth in the morning, nor does it change the value of human relationships in our lives.

Ultimately, the Internet makes it so easy to find a specialist who's the best at delivering packages or doing payroll or cleaning offices, or that the costs of interacting and doing business with these specialists have decreased dramatically—for you, your customers and your competition. But this idea that the Internet has revolutionized business models is just plain wrong—many of these “new” Internet business models are failing.

The conventional wisdom a couple years ago was that the Internet and CRM



The Internet's real potential lies in its ability to transform relationships within the traditional supplier-vendor-customer chain.

solutions could enable companies to directly target, sell to, and service all of their customers, be they consumers or businesses. High-profile ventures like Amazon.com, Dell, and E*Trade helped to hype the Internet as the means to disintermediate, or cut out the middlemen. The theory was that these indirect sales channels weren't necessary anymore, because it is now faster and cheaper to deal directly with end customers.

Yet indirect channels remain of vital importance in reaching target markets, adding consulting and services, and providing total solutions. Think about it: The last time you bought a car, you could've bought one online. Did you?

“The whole idea that the Internet is going to disintermediate channels doesn't

make a lot of sense,” says Chris Selland, vice president of marketing at Boston-based eSupport Now. Take car dealerships: It's possible to buy a car online, but people like to touch and test drive. Just because the Web lets you buy online doesn't mean that it's the best way to do it. Besides, it's hard to get your car serviced over the Web.

An “eCash Register” is Not Enough

The Internet occupies an interesting place in the customer value chain. Whereas in the early days of e-commerce it was expected to rapidly become the preferred method of purchase, it hasn't quite worked out that way. More and more it's used as a means for customers to gather informa-

tion before purchasing. Customers can find a wider array of products online, more and more sites are letting customers design custom products, and the costs of servicing customers online are far less than with human representatives.

While such experiences do increase value for customers, they don't point to the Internet as a cash cow. According to a report released earlier this year by Jupiter Research's Media Metrix, on nine percent of customers, use the Internet “mostly for purchases.” Other studies have found that while the Internet is a fast-growing new channel, this growth has not come at the expense of indirect channels, which continue to be used extensively. Bottom line: the Internet is not eliminating intermediaries.

That said, intermediaries must adapt to a new reality where merely moving products and information is not enough to make a profit and survive over the long-term. The key is delivering value, perceived from the customers' point of view. The Internet is changing the definition of what customers expect and will pay for.

Confusion is rampant on this point. Are providers failing to capture the value from their investments in Web technology just because people aren't buying from Web sites? After all, companies are spending time and money to maintain their Web presence. Maybe the rich content the Web presence offers is all that's required of a Web site—maybe that's all people want to use it for.

The awkward human fact is that people rather like switching off their computers and tooling around town once in a while. Driving to the grocery

store gives them something to do. There's no percentage, as Jazz Age colorist Damon Runyon would say, in trying to force the Internet to be something that it's not.

Logic In The Paradox

If the Internet is viewed primarily as a sales or purchasing channel, then you can call it a disappointment. Viewed as a channel for sharing information and servicing customers, which seems to be the real-world view, it's succeeding wonderfully.

The real payoff of the Internet is in its enabling of business collaboration—the sort of three-way “information partnerships” among manufacturers, business partners and customers. Michael Dell, in his book *Direct from Dell* said, “The

Internet as a sales channel represents only a fraction of the Internet's value to business. The real potential lies in its ability to transform relationships within the traditional supplier-vendor-customer chain.”

Even business partnerships, once thought doomed in the New Economy, are thriving online. Look at Dell, probably the world's largest consumer of disk drives. You'd think they'd be out on the spot market every day, checking for that day's cheapest supplier in the extremely price-sensitive disk drive market to save a few dollars here and there. Wrong. Basically, Dell has locked in one supplier of disk drives with a long-term contract, and has another as a backup.

There's logic in what some might consider a paradox. The Internet can lead to deeper partnerships because

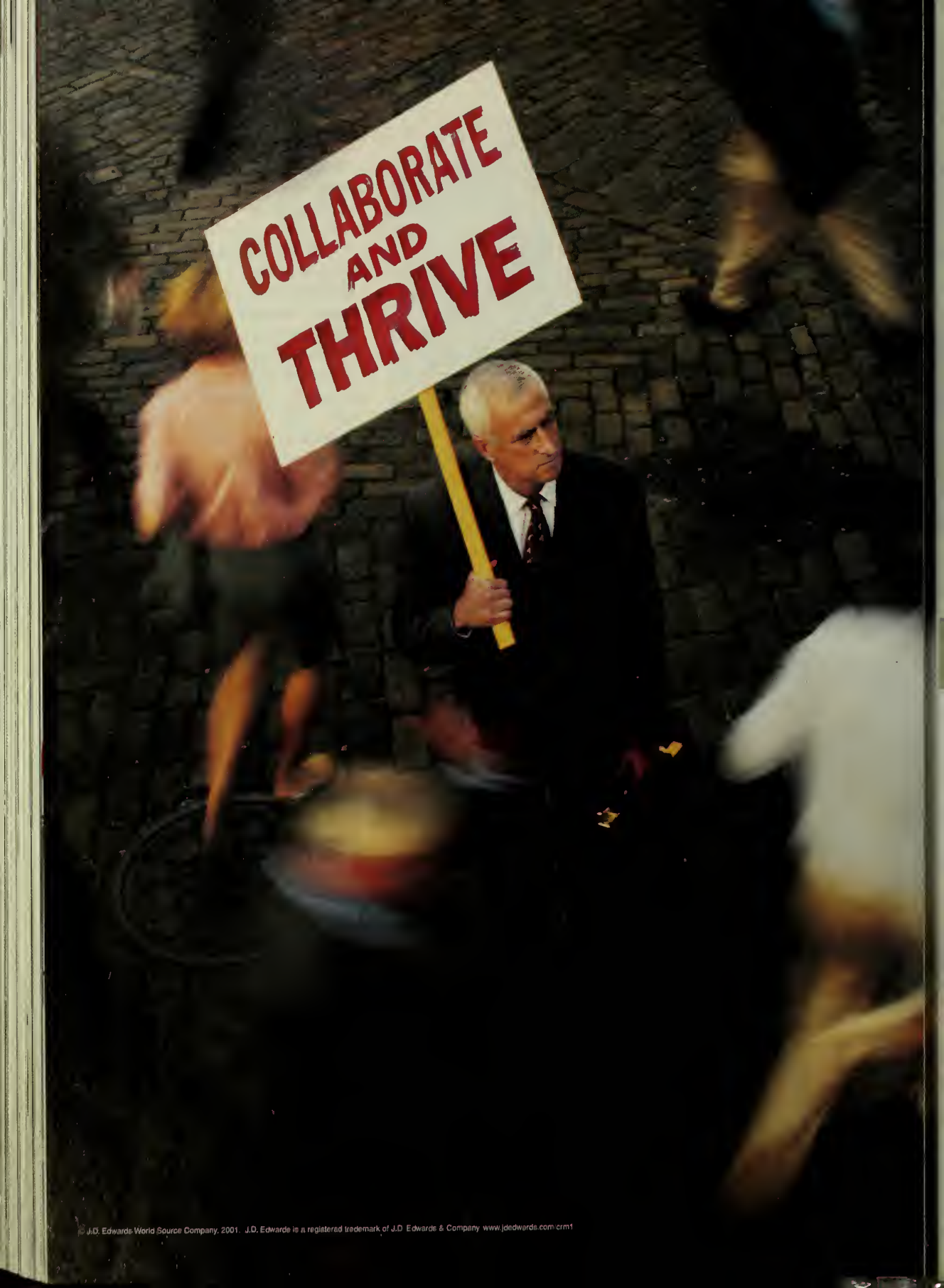
Today the vast majority of consumers worth chasing are online, and are comfortable communicating online.



companies won't feel at risk in throwing all their business to one supplier. Now you can check easily if you're getting a good deal, and make a change if you think you can do better. Power in the relationship has shifted from seller to buyer, leading to stronger relationships all around.

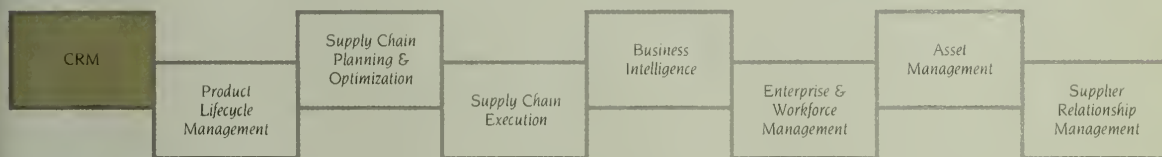
Today, says Ross Brown, president of Seattle-based market planning firm Sound Consulting, the vast majority of consumers worth chasing are online, and are comfortable communicating online: “For the first time, customers' information can be centrally located and updated.” Call centers were the genesis of CRM, and now we're tying in dealer networks as well, so this is the first time large-scale manufacturers are back in the position of a 14th century craftsman, who heard directly from his customers.

The Internet will bring massive changes to the business partner relationship as well as to customer interactions—at this point we're just scratching the surface.

A high-angle, slightly blurred photograph of a man in a dark suit and tie walking through a crowded city street. He is holding a white rectangular sign on a yellow pole. The sign has the words "COLLABORATE AND THRIVE" in bold, red, sans-serif capital letters. The background is a dark, cobblestone-paved street with many other people in motion, their figures blurred to convey a sense of a busy, fast-paced environment. The lighting is somewhat dim, suggesting an overcast day or late afternoon.

**COLLABORATE
AND
THRIVE**

If you don't collaborate with your customers, someone else will. Customers are driving the market. Fail to keep them happy, and one of your competitors will. So what's the secret to customer loyalty? It's better collaboration. Precisely what you get from our collaborative commerce CRM. It provides the customer-facing applications to deliver world-class service and support. Plus the full suite



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J D E D W A R D S

CRM and the Internet



What's new is that the Internet allows businesses to look for efficiencies *outside* their walls, to try to streamline interactions with business partners and suppliers so completely that all the different companies operate as one. But we still have companies, relationships, competition for business, and we still use channels. The bar, though, has been raised.

CRM: A Customer-Centric Business Strategy

Customer Relationship Management (CRM) is a business strategy to select and manage customer relationships to optimize long-term value to an enterprise. CRM requires a customer-centric business philosophy and culture to support effective marketing, sales and service processes across all direct and indirect customer interaction channels. CRM software applications can enable effective Customer Relationship Management provided that an enterprise has the right strategy, leadership and culture.

Source: CRMGuru.com (www.crmguru.com)

The Evolution Of Relationship Management

CRM must start with a business strategy, which drives changes in the organization and work processes, which are in turn enabled by Information Technology. The reverse does not work. Have you ever seen a company automate its way to a new business strategy?

The seeds of modern-day CRM were sown in the 1960s. Academic researchers found that the "4 Ps" marketing framework—product, price, place and promotion was less valuable for industrial or service-centric businesses where ongoing relationships were critical. By the 1980s, "Relationship Marketing" was used to describe this new focus on understanding customer segments, delivering ongoing quality service, and achieving high customer satisfaction.

Relationship marketing was about "putting the customer in the middle of the business circle," in the words of Dick Lee, principal of St. Paul-based Hi-Yield Marketing. "As part of that early relationship marketing movement, we had untold frustration because we didn't have the technology to support what we were doing," Lee says. "It really

wasn't until mid-90s that we had the technology we needed."

In the 1990s, computer systems were deployed to support sales and service processes. Sales Force Automation systems quickly evolved from simple contact managers, while Customer Service and Support systems became the backbone of automated call centers. By the mid-1990s, "CRM" became the umbrella term as it became clear that sales and service systems should share information. More recently, Enterprise Marketing Automation (EMA) applications joined the CRM fold, including systems for customer analysis and marketing campaign management.

By the late-1990s, the real action was outside the corporate firewall. Explosive growth in Internet usage spawned a proliferation of e-business applications to manage online customer and partner relationships, often called "e-CRM" and "Partner Relationship Management," respectively. Now, "multi-channel CRM" systems were available to, theoretically support direct, Internet, and partner channels, while allowing users to use whatever mode of communication they pleased.

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Give Mobile Workers What They Need, When They Need It

PeopleSoft's objective is to support the critical processes necessary for professionals to do their jobs. For example, a sales rep may need access to customer contacts, opportunities, and forecast information, but not all functions in a full CRM system. Simplifying the mobile application also eliminates the headaches associated with installing and maintaining large remote applications.

Whether mobile workers are accessing enterprise applications by wired or wireless Internet, dial-up, or LAN, they can employ:

■ *Connected applications*—using a wired or wireless network connection to provide real-time data access. This is ideal for mobile workers dependent on up-to-the-minute information such as product availability or delivery dates.

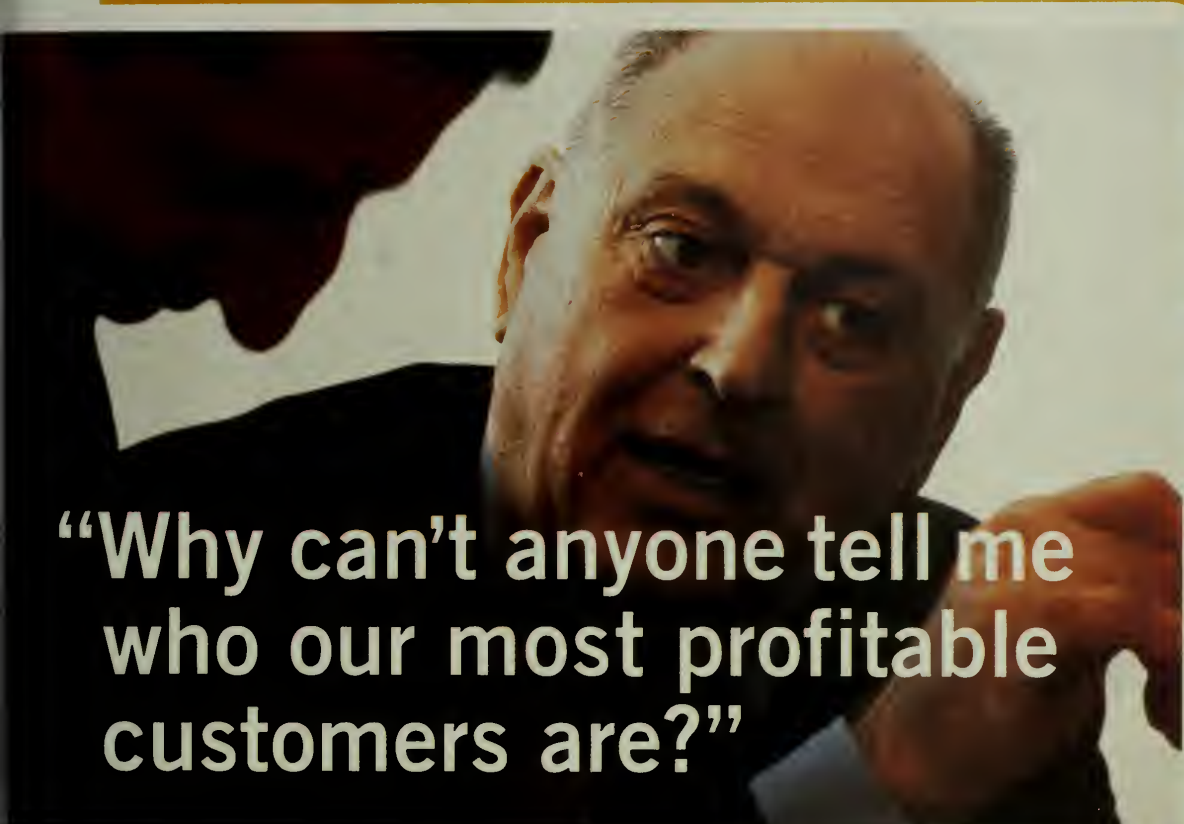
■ *Disconnected applications*—using PeopleSoft's patent-pending technology to function without Internet connectivity. Users can download refreshed data upon demand and upload new or updated data when it's convenient.

Since mobile devices will be used in a wide variety of conditions, ease of use is critical. PeopleSoft Mobile Applications provide a similar look and feel between connected and disconnected counterparts and optimize the user interface for mobile devices.

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CRM and the Internet



the multiple touch point issue to the forefront, and in many firms, the left hand doesn't know what the right hand is doing." Customers might start researching product information on a Web site, then pick up the phone to get a crucial question answered, then do the actual buying with a local distributor or retail outlet. The challenge now is for companies to present that single face in all these real-world scenarios.

Why is this so difficult? The root of the problem is simply the fossilized ways that companies treat information—dump it in a "silo" (otherwise known

a lot of stress in an organization that will probably resist such changes. You also have to bend and reshape your internal technologies to support customer-centric, rather than silo-centric business processes.

"This situation is driving interest to new CRM approaches with environments that can offer greater central control or management," says Karen Smith, senior analyst with Boston-based Aberdeen Group. "Organizations are demanding CRM solutions that provide greater visibility into asset management, forecasting and inventory management, product development, procurement, and order and also transaction management."

It's clear that the Web is making the inefficiencies and inconsistencies of big companies transparent to customers and partners. To win the battle for customer loyalty in the future, companies must shift from stand-alone business technology approaches to systems that support the total customer experience and work across multiple enterprises.

Much of what satisfies customers is the company's ability to preserve the 'single face' of a customer.

Left Hand, Meet Right Hand

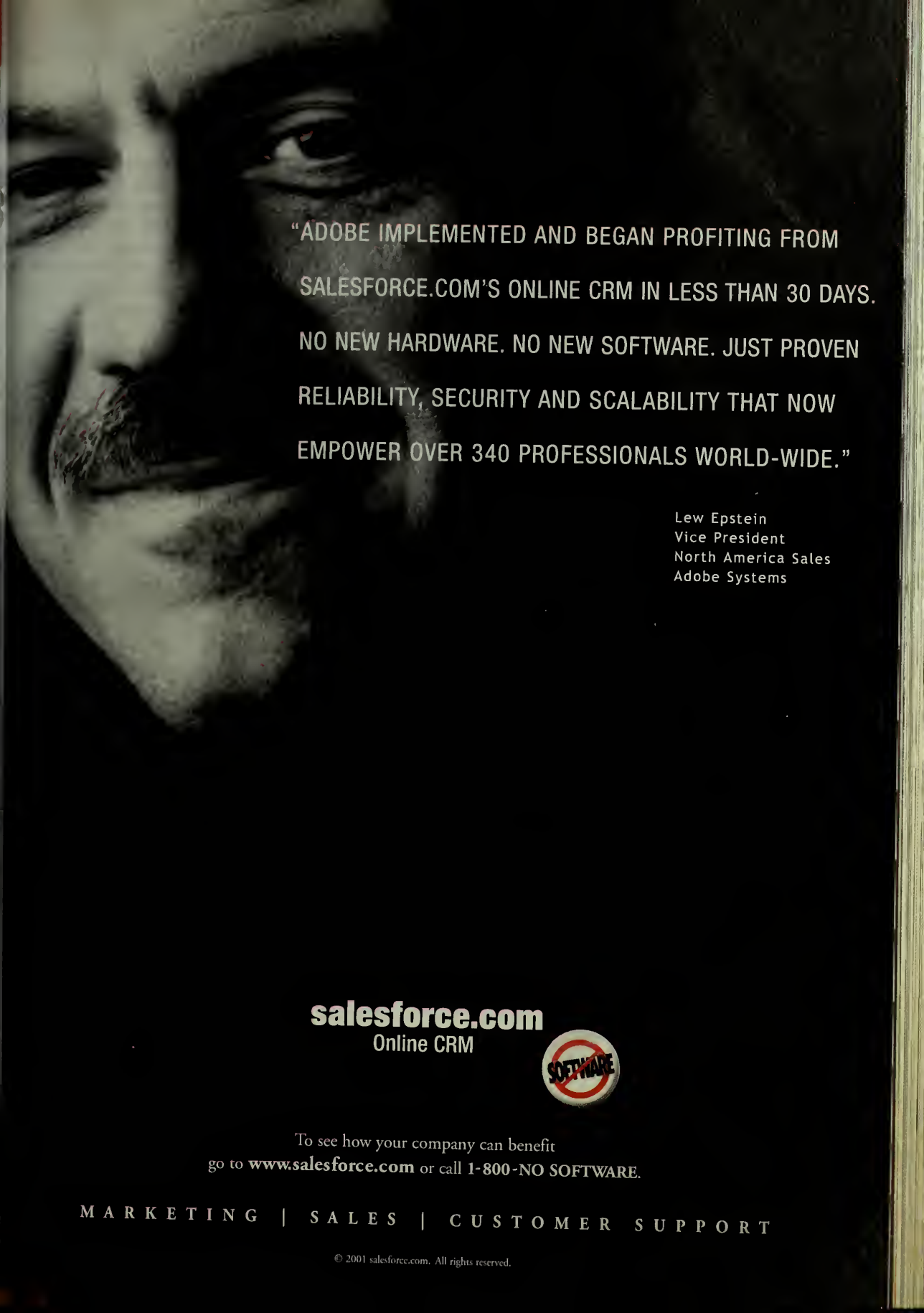
Much of what satisfies customers, of course, is a company's ability to preserve the "single face" of a customer. Some companies are semantically confused and think the customer wants to see the company's "single face." Customers don't care about that. What they want is for the company to always see their—the customers'—full faces.

To see how it works, go to Amazon.com and click on "Your Account." The record of all your transactions, your credit cards, your shipping and billing addresses, the status of all your orders from last year to five minutes ago is there. It's like looking in a mirror. Talk to anybody from Amazon at any time, and they can swiftly deal with your concerns because they see your total dealings with their company. This is what is meant by "single face," and there's no better example of it than Amazon.com. You want every company you deal with to be able to do this.

Unfortunately, that's rarely the case. "With the Internet, companies in the present are still pretty bad about presenting a single face to the customer," says Jeet Singh, CEO of Cambridge-based ATG, Inc. "The Internet has blown

as a department, division, or business unit) and then defend it from the rest of the organization. If you figure out how to redesign workflow to make for happier customers, you're taking a jackhammer to functional silos, creating





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CRM and the Internet



**It's incumbent upon the vendor,
not the customer, to do whatever it takes to
keep the relationship in good working order.**

The Next Evolutionary Step

If your relationships with customers are getting more important, so are your relationships with your partners. "The common assumption is that the Internet helps companies find partners. Our experience is that it helps less with finding new partners than allowing companies with complex supply chains to maximize inter-enterprise relationships," says Michael Levin, founder and CEO of e-Steel. "This is not like a cruise line for singles to meet, it's a cruise line for couples to have a great time."

And, of course, it's the Internet that makes it all possible. "Part of the evolution of CRM from a focus on internal efficiency to more effective external relationships is the ability to move information around about a customer

which has become viable recently," says Scott Sims, partner with Chicago-based Andersen Business Consulting. "The Internet also has the ability to make alliances stronger. If you build a site that shows how your partnership benefits the consumer, you also can benefit greatly."

"Everything needs to tie into your overall CRM strategy," says Scott Creighton, general manager of Siebel Systems' eChannel Applications Dallas office. "However, you've got companies with homegrown silo systems, their own internal tools for managing marketing incentive funds, and partners have to use a call center which then places the order. What companies are trying to do now, under increased pressure to perform, is to consolidate all these

tools into an Internet-based system so that channel managers and their partners have the tools to drive revenue."

Bear in mind that while customers expect to have their needs met, the character of the relationship isn't top of mind for a customer in the same way it must be for a vendor—at least until the relationship turns sour. It's incumbent upon the vendor, not the customer, to do whatever it takes to keep the relationship in good working order. Earlier ideas about customer satisfaction dealt with keeping the customer happy after a purchase transaction took place. In this Customer Economy, however, waiting for the PO to provide good service may be waiting too long.

And let's not forget, good collaboration starts close to home, in your company. "In the early days, says Keith Raffel, chairman and founder of Mountain View-based UpShot Corporation, you ask a sales rep if he did collaborative sales, and he'd say he didn't. Then you walk him through all the steps internally that his sale has to hit, and he'd realize it's a very collaborative process." Collaboration is just as essential inside the enterprise as it is for channel partners, system integrators, agents and so on.

Partner Relationship Management has made great strides helping companies get used to the idea that their partners and channels are as crucial to their success as their customers or internal operations. Now, with business hurtling towards a collaborative future, managing integrated relationship networks will be essential. These C-Webs must provide the structural frameworks to keep a single face not only for all your customers, but business partners as well.

Instead of just automating individual channels, a collaborative e-business environment has to support complex many-to-many relationships, whether they're partner-to-partner, partner-to-customer, or whatever. If you think this means your job just got tougher, you're right. But with that challenge comes a new opportunity to gain, or lose competitive advantage.

Technology for Collaborative Relationship Networks

In the next five years, instead of just automating individual channels, collaborative e-business solutions will support more complex many-to-many relationship networks. In addition to optimizing vendor-to-partner relationships, as CRM solutions do today, collaborative solutions will ensure that the enterprise, partners and customers can all work together in a profitable relationship network or "C-Web."

The same competitive forces that pushed CRM to become a multi-billion dollar industry in a few short years are now driving C-Webs. Competitive advantage based on a "hot product" is fleeting. Increasingly, enterprises must create tighter, collaborative linkages with partners, suppliers and customers, squeezing out time and costs while enhancing the customer experience and total value proposition. In the future, automating individual relationships, the current state-of-the-art with multi-channel CRM, will not be enough to create a sustainable competitive advantage.

As the diagram shows, traditional CRM is shifting outside the enterprise. First, to customers and partners in the



eCRM and PRM trends. Then, over the next few years, to a multi-enterprise or "collaborative e-business" approach to enable business process integration, content management and work team collaboration. Goal: create, grow and retain profitable networks of customer and partner relationships. Sounds a lot like CRM, doesn't it, just updated for the interconnected world, the real world in which we live.

The Important Tools

Knowing what problems you need to solve is 51 percent of the solution. Walk into Home Depot and you're inundated with a thousand tools. It's hopeless—unless you know you need a screwdriver. That cuts 98 percent of everything available out of the discussion. You need a Phillips screwdriver? There goes another 1.5 percent. You have six dollars to spend? Now you're down to a manageable selection. Now what color would you like?

Any technology works the same way. All those fancy gizmos, no matter how pricey or complicated, are merely tools to solve your business problems and improve your organization's ability to please customers. Nevertheless, you'd be surprised about how many CRM implementations court disaster by purchasing technology with only a vague, sketchy idea of what tools are actually needed.

Here's what you're likely to find in the aisles of a store full of B2B collaboration tools:

■ **Lead and Opportunity Management.** These tools help deploy sophisticated systems to target leads to the

Shifting Automation Focus

Enterprise → Channels → Relationship Networks



CRM and the Internet

most qualified partners, based on certification, geography, or other business rules. These leads can then be accessed via a secure extranet by the targeted partner. But watch out for "death at the browser interface." Next-generation systems will allow vendors and partners to exchange leads and lead status information through process integration, rather than forcing visits to yet another portal.

- **Order Management.** Early on, vendors experimenting with e-commerce discovered their channel partners wielded considerable market power and were none too pleased to be cut out of the flow of business. Distributed e-commerce systems allow customers to visit a vendor's Web site, do some research, then fill a shopping cart. The vendor's site helps the customer pick the appropriate partner, based on geography, price or other factors, and the shopping cart is electronically transferred to the selected partner's site. This is great collaborative e-business, leveraging the strengths of each party.

- **Service Incident Management.** Post-sales service and support is a costly fact of life in any business. Collaborative service systems help glue customer service processes together across multiple organizations. A customer service request can be tracked across departments or companies using a single Web page, much like you'd track a shipment via the FedEx Web site.

- **Integrated Marketing Portals.** Portals have limitations in B2B processes, but they're a great way to reach consumers. Effective portal tools use XML to aggregate content streams from multiple parties, then syndicate this information in a consumer-facing portal. If the content changes at the source, it's changed in the portal automatically without requiring a slow and costly traditional Web publishing process.



A fundamental determinant of your CRM tools' success will be how well they integrate sales, service and marketing functions.

- **Team Collaboration.** People still do the real work in complex selling and service scenarios. Even with robust relationship management systems, people still need to interact using e-mail, desktop documents, project plans, etc. Collaboration tools allow companies to manage this unstructured information via shared workspaces that can be used by customers, partners and employees. Using such systems can help an enterprise rapidly form teams and enable people to work faster and smarter. That's a good idea in any economy.

Choices, Choices

It can't be stressed too frequently that a fundamental determinant of your CRM tools' success will be how well they integrate sales, service and marketing functions. The more effectively they work together in presenting the single face of the customer

to all possible touch points across your relationship network, the more capable your employees and partners will do their jobs, at the lowest possible cost.

Ease of use is also critical. When in doubt, keep it simple. Technically elegant but hard to use systems will not be accepted, and you won't get the payback you seek.

Choosing the right solution can be challenging in a multi-billion industry selling CRM and e-business technology. In theory, you have hundreds of choices. But in reality, after you've detailed your top customer-driven requirements, you should have narrowed the field down to a small number of practical choices. If you haven't, you could very well end up needing a screwdriver and buying a riding mower.

If you're still confused or overwhelmed, look at the vendor's client list. Would you fit comfortably there? If not, keep looking.

Is your technology missing something?

responsibility

Who's responsible for your hardware?
Your software? Your integration?
Your network? Your security? Your
support? For many companies, these
are difficult questions. That's where
the leading Application Service
Provider comes in. USinternetworking
partners with Ariba®, BroadVision®,
Lawson®, Microsoft®, PeopleSoft®
and Siebel Systems® to deliver the
best application software over
our own state-of-the-art network.
We take total responsibility for every
aspect of your application from
implementation to support – all
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Making C-Webs Work

Why should you be investing in the technology for business channels at all? Because the essence of channels is to match the right people and resources to the right jobs, at the lowest cost. Plus, no company can afford to serve every market in the world directly. The world's largest and most successful companies don't try to do that. General Electric uses channels, GM uses channels, Microsoft, overwhelmingly, uses channels.

Does Exxon sell only through Exxon-owned outlets? No, they sell through thousands of independently owned and operated channel partners. In the IT industry, Value Added Resellers are still vital to hardware and software firms.

Channels were supposed to be obsolete with the Internet, remember. We were all going to be Amazon, selling direct, goodbye partners, the Web's the only channel we need. Well, companies woke up and realized they'd been doing a profitable business with channel partners for generations. So they decided not to get rid of their partners, but to use the Internet to support their partners. They started investing in those relationships, not bypassing them. Today, smart enterprises use the Internet to push information to partners, instead of trying to reach around the partner to grab that customer for themselves.

Why Does It

A PRM study Front Line Solutions conducted over the past 18 months bears this out. South African financial services firm Liberty Group reported that "we select our partners based on the relationships they have with customers," meaning that channels were the main strategy to access the target market. Other companies saw partners as a critical sales channel, commenting that the key to success is to get the channel to support the company and recommend their solution to prospects." A typical comment

was along the lines of "we want to be the easiest company to do business with."

That last sentence is a key to successful partner and customer collaborations. If you want to do more business with partners, sometimes it's a matter of making it easier for them to sell your products. This means giving them up-to-date product specs and collaterals, especially for high-tech products. Alert your partners when you change something — it sounds like a small thing, and it is, but it's critical. It doesn't have anything to do with up-selling or cross-selling to partners, it's about just making it easier for them to understand and sell your products.

The best partner collaboration systems, almost anyone will tell you, by definition are the easiest ones to use. Quite simply, the easier the system is to use, the more hits there will be. Easier to use means easier to do business with.

Don't be afraid to actually approach partners and users. "We called both large and small dealers and asked, if we built a comprehensive, information-rich Web site, how much time would it save per week, especially on the sales side," says Executone's channel marketing manager Paul Lavallee. "We also assessed the impact on specific departments within Executone."

One other thing: Don't compete with your partners. The biggest business mistake is competing with business partners. Either leverage or kill your business channels. If you waffle in the middle, you can get killed. If you think you need lots of local service, then you can leverage your local relationships. If you don't, it might be best to kill them off. Companies who try to have their cake and eat it too, unfortunately, usually end up by hacking everyone off. Think of Dell Computers, who in a gutsy move gave up their account with Staples, at a time when it was a multimillion-dollar profit maker. They did it because they decided their best course was to focus on their business model.

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CRM and the Internet

Hub, Spoke, or Toast

We're living in a networked world—business ecosystems of partners and customers. Companies must be a vital hub or spoke, or else risk the same fate as failed dot-coms that couldn't deliver value at a competitive cost.

A McKinsey study discovered that "network orchestrators" like Cisco, Schwab, Palm, and Qualcomm outperformed their peers, not only in the boom times of 1995 to 2000, but even during the recent downturn. IBM, Microsoft, and many software developers owe their success as much to their partner networks, as to their products.

Shared benefits are the essence

of collaboration and should be part of a vision for world-class CRM. John Dillon, CEO of San Francisco-based salesforce.com, agrees that CRM is already heading in this direction. "CRM applications used to be inwardly focused, but now executives want to reach out to customers to create a better bond and ultimately better relationships."

In the collaborative future of CRM, customers reap rewards by receiving the products, services and interaction experiences that they want, at a cost they can afford. Partners, true value-added intermediaries rather than mere product-pushing or paper-shuffling middlemen, earn the trust and loyalty of both customers and suppliers. Profitably. And enterprises enjoy a sustainable competitive advantage built on loyal rela-

tionships, maximum market reach, and efficient business-to-business processes.

This collaborative e-business world will be as tough, and likely tougher to achieve than what we've known as CRM. New standards like XML and Web Services must mature. New applications must be developed to make B2B integration easier and less costly, and cultural issues must be overcome.

The effort is worthwhile. To increase your odds of success:

- **Drive everything from a customer perspective.** Start from the very top of the business. Check your ego at the door; act like you work for your customers and partners, not vice versa.
- **Dare to share vital business information with partners and customers.** Work through inevitable security issues and occasional misste-



**Shared benefits are the essence of collaboration
and should be part of a vision for world-class CRM.**



While you're learning, however, be smart about the risks you do take. **Think, plan, and then do.** Focus on business problems and processes that are truly critical to the success of your relationships before selecting the tools. Can you imagine building a new home without a vision, architect's drawing and a construction plan? **Motivate and monitor adoption rates.** Think traditional CRM was hard? You'll need to work even harder to encourage partners and customers to buy-in and use new systems supporting relationship networks. Keep at it—you'll never be completely done. **Remember, it's still about people.** At the core of successful relationships,

networked or otherwise, are real people of flesh, blood and emotions whose main question is: "What's in it for me?" Better have an answer ready. Collaboration is not just another buzzword, and neither is CRM. Collaborative Relationship Networks should deliver clear benefits to all parties. That's a competitive edge every company needs in the Customer Economy.

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Bob Thompson is founder and president of Front Line Solutions, an independent CRM consulting and research firm. Mr. Thompson is a leading authority on the role of CRM in the extended enterprise, specializing in emerging CRM-related strategies and technologies for Partner Relationship Management (PRM) and Collaborative eBusiness, an emerging trend that is the fusion of eCRM, PRM, and collaboration tools. Throughout his career, he has advised leading companies on the strategic use of Information Technology to solve business problems and gain a competitive advantage. Mr. Thompson is also editor and publisher of *CRM Insight*, an award-winning CRM newsletter. In January 2000, he launched CRMGuru.com, which has become the largest and fastest-growing CRM portal. It is expected to reach 100,000 members worldwide by year-end. For more information, visit the Front Line Solutions Web site at www.frontlinehq.com or CRMGuru.com at www.crmguru.com.

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COMMENTARY

By Michael J. Mandel

WHY MARKETS MISBEHAVE

We live in a world where much is unknown or hidden, and where partial knowledge is a fact of life. Not surprisingly, much of the best work in economics in recent years has concentrated in areas such as finance, where uncertainty plays a crucial role.

Now, the latest Nobel prize in economics, announced on Oct. 10, goes a step further in highlighting the role uncertainty and information play in economic thinking. George A. Akerlof of the University of California at Berkeley, A. Michael Spence of Stanford University, and Joseph E. Stiglitz of Columbia University received the award for their separate work on "markets with asymmetric information."

Put simply, the economists won for their study of markets in which some people have information that others do not. That includes a wide range of situations. For example, a worker applying for a job knows more about his or her strengths and weaknesses than the potential employer. And a company applying for a loan knows more about its true financial prospects than the bank.

The economics of asymmetric information sends a simple message: Markets behave in odd and surprising ways when there is unequal access to information. And, under these circumstances, there may be room for government intervention or regulation to make markets work better.

NEW VIEWS. The selection of Akerlof, Spence, and Stiglitz gives a lift to those economists who argue that there's a wide gap between the ideal of free markets and the reality of an imperfect world. Akerlof and Stiglitz, in particular, have in recent years argued against conventional policy prescriptions. In his latest paper, Akerlof shows that a little inflation can actually lower unemployment. And Stiglitz has vehemently argued that requiring developing

countries that want loans to cut wages and raise interest rates is bad policy, although it was the main prescription of the International Monetary Fund for many years.

Despite these views, all three are card-carrying members of the economic Establishment. Stiglitz was chief economist of the World Bank and head of President Bill Clinton's Council

want to buy insurance. But that drives up rates, making it less likely that healthy people will sign up for insurance, which pushes up rates even more. This explains the need for universal health insurance, in the form of Medicare, for the elderly, to prevent such adverse selection—and it also suggests one reason why it is so hard to construct a satisfactory health-insurance system today.

The same sort of unraveling can happen in credit markets. In the early 1980s, Stiglitz, along with co-author Andrew Weiss, argued that during downturns banks will tend to ration credit rather than simply raising interest rates enough to cover loan losses. The reason: Businesses that suspect they are going to be in big trouble are more likely to ask for loans, at any rates, in order to survive. That means that



The latest Nobel winners show what happens when some have more information than others

CLOCKWISE FROM RIGHT: SPENCE, STIGLITZ, AKERLOF

of Economic Advisors.

Spence, now a partner in a venture capital firm, was dean of the Stanford Business School for nine years.

The research for which they received their award dates to the 1970s and 1980s. But in many ways, the question they studied—how markets misbehave in the presence of asymmetric information—is relevant today. Consider health insurance, one of the toughest issues Washington faces. It might seem reasonable for individuals to buy their own health insurance, just as they buy cars or houses. But Akerlof's research implies that health insurance suffers an "adverse selection" problem that causes normal market processes to collapse. That means people with bigger health risks are more likely to

during recessions, banks will tend to choke off credit, making the downturn worse. This suggests a need for activist monetary policy to counteract the tendency to ration credit.

Or consider college admissions, one of today's odder markets. In the 1970s, Spence showed that attending a selective college is valuable, in part, because it is a way of showing future employers—"signaling," in Spence's words—that you are smart enough to get into a selective college, and hardworking enough to graduate.

There's plenty more. The latest Nobel prize is a sign that the economics profession is truly moving in the Age of Information.

Mandel has a PhD in economics from Harvard University.

THE FUTURE OF NEW YORK

Can the moxie and markets of this wounded global city come back?

MITCHELL FUNK/IMAGE BANK



YORK

or and recession?

■ BY BRUCE NUSSBAUM



It is, and has been for four centuries, a culture of creative congestion, a miasma of intense interaction, a kaleidoscope of diversity, a cauldron of dreams, a sanctuary for the odd, the hunted, the hated. New York. It's an ill-fitting city in many ways: not "American" enough for America—too polyglot and raucous, too rude and rapacious. It's a place where the marketplace dominates the church, crowded streets replace the open frontier, foreign tongues displace the nation's English, and the economy faces out toward the world rather than into the hinterland.

While America was building a distinctly transcontinental culture, New York was

making something else: a global culture. If, over the centuries, America was often appalled by the disorder of New York, the city's vision of an open, pluralistic society built on international commerce and diversity attracted millions and fascinated the nation.

Even before September 11, the U.S. was ready to embrace the city, for the country had already become much like New York. A huge new wave of immigrants had made the rest of America look and behave much more like Gotham. An internationalization of business practices had tied the national economy tightly to Asia, Europe, and Latin America, echoing New York's. An army of young people from Boise and Duluth, Portland and Cleveland, had joined native New Yorkers in making the city their home, taking jobs in the industries of the growing global economy—finance and media, marketing and law—and leaving nervous parents behind.

Then came the terror attacks that took so many lives, not just from New York but from across America and around the world. The city showed that beneath its glitter and greed there was heroism, selflessness, community, and charity. It was clear that the values that mattered most to America had been nurtured in New York, too. September 11 marked the end of the city's isolation and made it whole with America—perhaps for the first time, long after it had become the world's capital. The World Trade Center tragedy finally brought New York home to America and America home to New York.

A SINGLE PURPOSE. From the beginning, New York showcased the promise and problems of an open global culture. It drew people from around the world with restless ambitions and towering hopes for a new life. In 1624, the Dutch laid down rules that remain to this day. There was one, and only one, central purpose for New York, a secular *raison d'être*: making money. Since all of the early settlers of New Amsterdam, as it was originally called, were employees of the Dutch West India Company, there was a clear logic to it. To this end, all religions, ethnicities, and races were forever to be tolerated. When Peter Stuyvesant, director general of New Amsterdam, tried to ban Quakers from praying in the city and Jews from entering it, company directors rebuked him, arguing that these people, as well as all New Yorkers, were to be treated not as religious figures but as businessmen. Freedom of religion in America gained support in New York, not merely because it was right but because it made economic sense. Men and women were entitled

to pray privately in whatever fashion they chose, but the public arena—the marketplace—would forever be secular. That would make New York the apotheosis of a new modern global culture, the exemplar of pluralism, the epitome of democratic capitalism.

A global city, however, will suffer the exigencies of global events. In the mid-1960s and '70s, New York lost its way. Its manufacturing base was decimated by overseas competition, and the city lost 600,000 factory jobs. Crime rampaged through its dirty streets. Its once-great public schools and colleges began to fail. New York's traditional ideal of tolerance for diversity was debased, turning into an indulgence of the worst public behavior. Tourists were robbed; residents were mugged. By 1975, the city had fallen into default, and the *Daily News* was running the headline "Ford To City: Drop Dead."

But then New York came back as it always has. Financial and business leaders joined together to restructure the city's debt. The streets were made safe again. Welfare reform was slashed. A new wave of immigration reinvigorated its small businesses. New York reached out to Middle America, bringing in Democrats to clean up Times Square and help rescue tourism. The global economy soared, and New York-based advisers, accountants, designers, lawyers, and investment bankers serviced multinational corporations. Most important, the stock market began a 20-year rise, and Wall Street boomed.

True, there were still problems. The cost of living and doing business in New York remained extremely high. Corporations and their employees felt pressure to disperse and escape to the less-expensive suburbs. Poorer neighborhoods were neglected. The public schools remained a mess, and heavy borrowing to build bridges and tunnels burdened New York with a groaning debt load.

Yet to most living in New York in the '90s, it was a glorious moment. The city was ascendant and reigned supreme in the global stage. Its capital markets dominated the world, fueling growth, jobs, and prosperity. New electronic media in Silicon Alley attracted a horde of young dot-commers, competing to be on the boards of ballet and opera companies and the best museums, helping to finance a surge in arts.

Much of that is now in question. New York will have to turn to its strengths to survive and prosper again. Even though the city was blessed with one of the greatest ports

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BusinessWeek online

For continuing coverage of the economic aftermath of the terrorist attacks, go to www.businessweek.com.



th, its keenest advantage was the financial markets New Yorkers recreated time and again. In 1792, in order to fund the country's first public-federal debt, two dozen brokers and speculators gathered under a cottonwood tree on Wall Street

to formalize a system of standard minimum fees for the buying and selling of securities. This was the beginning of the New York Stock Exchange; the market sold U.S. government securities, not for the last time, to British and European investors.

STREAMLINING FINANCE. Two centuries later, Wall Street could hire mathematicians and physicists to break securities down into their derivative parts, thus stripping, reshaping, and streamlining the nature of finance, making it far more efficient and powerful. The securitization of debt instruments allowed them to be sold globally, not just domestically, spreading risk and thereby reducing it. By the 1990s, New York capital markets were the largest and most sophisticated in the world. New York built an equity culture for the entire country, with soaring stock prices generating enormous prosperity for America, Europe, and Asia.

It is no accident that the skyscraper came to define New York. To scrape the sky with the dreams and aspirations of men and women drawn from around the world is to define the very essence of the city. New York is the only metropolis in America that was built to be dense and crowded from birth. Behind a 2,340-foot protective wall that became Wall Street, the Dutch laid out a miniature Amsterdam with a closeness

TOLERANCE
Diversity thrived in 1900—as it always has in New York—because it made economic sense

that forced an amazing diversity of nationalities to interact intensely, efficiently, and creatively.

Skyscrapers made it possible to fit even more people into New York. When the first one—the Woolworth Building—was built, in 1913, it held 14,000 people: “The population of a city,” said S. Parker Cadman in *The Cathedral of Commerce*, published in 1917. It symbolized “that spirit of man which, through means of change and barter, binds alien people into unity and space and reduces the hazards of war and bloodshed.”

Living high among the clouds is fraught with peril and full of hubris, but it is New York's way. After September 11, people realized that their way of life itself may make them terribly vulnerable. “The city,” as E.B. White said in a remarkably prescient essay in 1949, “for the first time in its history is destructible. A single flight of planes no bigger than a wedge of geese can quickly end this island fantasy, burn the towers, crumble the bridges, turn the underground passages into lethal chambers, cremate the millions.”

September 11 has struck deep fear in hearts of New Yorkers. Not since the Revolutionary War has the city been so attacked. Businesses are considering dispersing to New Jersey and Connecticut. Transportation to the financial district will take years to fix. The city's tax base will be hit hard as the economy sinks. The streets could once more become unsafe.

Or not. New York has risen, phoenix-like, again and again over the span of its long history. Even in this dark moment, media giants and investment banks are building to the sky, linking their fates and the city's to the currents of a global culture New York knows so well. For if New York is, as Walt Whitman said, a City of the World, that reality will carry it into the future. ■

The World Trade Center Tragedy Brought New York Home to America, and America Home to New York

The Center Must Hold

For the city's economy, critical mass matters more than ever

■ BY PETER COY

New Yorkers have always been proud to live in the nation's biggest and most densely packed city. But September 11 stirred a sickening realization: The bigger and denser a city is, the juicier it is as a target for terrorists. Skyscrapers? Targets. Bustling train stations? Targets. Crowded theater districts? Targets.

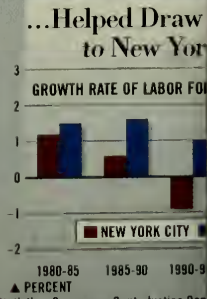
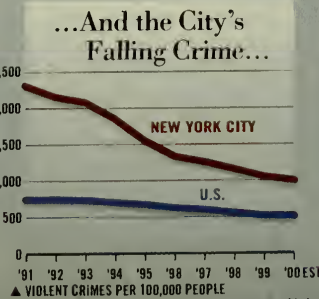
Suddenly, many New Yorkers are pondering whether they might be more tranquil across the river in Jersey City, up the train line in Stamford, Conn., or off in some picturesque part of Arkansas. Margaret Ann Thomas, a 29-year-old graphic designer in Manhattan, says her grandmother offered her a car and a downpayment on a house if she agreed to live anywhere but New York. She's thinking it over carefully. "If I wait for the next [attack] to happen to see what it is, what if I've waited too long?" asks Thomas. "What if I'm part of the next thing that happens?"

New York City has forever done battle with forces that could disperse its people, its companies, and its energies far and wide. High costs, congestion, crime, and troubled schools have at various times in the past called the city's future into question.

But the September 11 attack was the single worst blow New York has ever sustained. In an Oct. 4 report, New York City Comptroller Alan G. Hevesi estimated that the attack caused \$34 billion in property damage. The amount of Class A office space destroyed—about 13 million square feet—was equal to the entire office-space inventory of Atlanta or Miami. The loss of life not only sapped the city's spirit but



From Salad Days to Hard Times



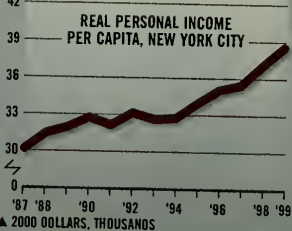
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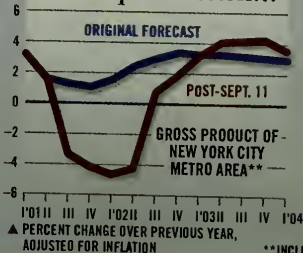
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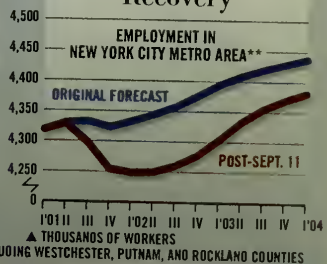
...And Driving Up Incomes



Now Forecasts Show a Deep Recession...



...And a Slow Recovery



PHOTOGRAPH BY MITCHELL FUNK/IMAGE BANK. CHART BY ALBERTO MENA/BW

Technology and fear are two forces working to disperse New York's awesome talent pool

also destroyed about \$11 billion in "human capital," the productive power of those killed.

Now, New Yorkers are asking whether the forces of dispersion will gain the upper hand, just as gravity seized its chance when the Twin Towers were weakened by air attacks. "Terrorism is posing a threat to the fundamental character of cities such as New York," says Mitchell L. Moss, director of the Taub Urban Research Center at New York University.

"It's going to be more difficult, more costly, and more time-consuming to do business here."

But there is a powerful force

counterposed to dispersion, just as there has always been in New York's history. It's the force of agglomeration, a kind of economic and social gravity that pulls people together. The best and the brightest from around the world are drawn to New York because it's where they can do their finest work and reap the highest rewards. Despite its drawbacks, New York is an indispensable global center not only for finance but also for media, advertising, and the arts, among other fields. Measured by payroll, the city, with less than 3% of the country's workforce, accounts for 37% of the U.S. securities industry, 20% of advertising, and 18% of book publishing.

TRUE BELIEVERS. That's why businesspeople in many fields can't imagine being anywhere else. "If I were in Indianapolis, this industry would not run as efficiently," says Paul Charron, chairman and CEO of women's apparel maker Claiborne Inc. "Italian pattern makers, the tailors, they all live in New York. I have a standing order with two or three search firms looking for great athletes in the design area. They all come from New York."

With a solid core of true believers like Charron, New York

Sizing up the Apple

According to the 2000 census, **8,008,278 people** live in the city's five boroughs. In order of size, they are:

Brooklyn (2,465,326)

Queens (2,229,379)

Manhattan (1,537,195)

Bronx (1,332,650)

Staten Island (443,728)

All five boroughs cover **301 square miles**, about three-quarters the size of Singapore.

On an average weekday, **4.3 million** people ride the subways; **2.2 million** people ride the bus.

There are about **774,000 buildings** in New York, or one for every resident of South Dakota.

The subway system has **656 miles** of track—enough to stretch to Cincinnati.

Manhattan island is **22.7 square miles**, **13.4 miles** long and **2.3 miles** at its widest point.

Central Park covers **843 acres**.

Data: NYC & Company, New York City Planning Dept., Metropolitan Transit Authority, U.S. Census Bureau





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York will almost certainly survive its latest trauma. Its staying power and adaptability for nearly 400 years have been enormous. Still, in the short run, the September 11 attack will hammer a nearly \$500 billion city economy already stumbling from the bear market on Wall Street and the nationwide slump. More than 100,000 New Yorkers will eventually be thrown out of work by the attack, according to New York State Labor Dept. estimates. Economy.com Inc., a forecaster in West Chester, Pa., calculates that the New York economy will end up contracting at an annual rate of 9% in the second half of 2001 and won't return to its pre-September 11 level of output until the middle of 2003. All told, Economy.com estimates, New York City will lose about \$90 billion in output over the next three years. Even though the economy will eventually accelerate, "there is a lot of output that will never be made up," says Celia Chen, a senior economist at the firm.

More worrisome, the attack could push some wavering companies to leave the city or at least shift out some operations. The nearly two-thirds drop in New York's violent-crime rate over the past decade was crucial to the city's revival. Now, fear is back. Many companies are deciding that it is prudent to spread operations over multiple locations on different electrical grids and telephone networks—and seamless communications make it much easier to do so.

Costs are rising, too, at the same time that the quality of life is worsening. With the Holland Tunnel beneath the Hudson River closed to inbound traffic and some commuter

train lines out of service, commuting times into the city many New Jerseyites have risen by 20 minutes to half hour. The destruction of downtown office space has pushed rents. New York's next mayor may need to raise taxes along with cutting services to balance the budget. Even insurers are getting more costly. Commercial-property insurers, wary that New York will continue to be singled out by terrorists as their No.1 target, are boosting quoted rates building owners in Manhattan by about 100%, according to Jacques Gordon, international director for research at Jor Lang LaSalle Inc., a Chicago property manager. That's compared with 30% to 50% increases in other cities, he says.

In the long run, the attack might well make Manhattan the engine of New York City's economy—into a more concentrated version of what it already is, the information center of the world.

par excellence. As costs and convenience rise, the businesses that choose to locate in New York's core districts will be the ones that absolutely must be at the very heart of it. For them, the rewards will be rich. Density creates tremendous advantages.

By locating close to their competitors, businesses have access to the largest pool of top-notch talent. They can share essential support services: costume and prop makers in the case of Broadway, specialized lawyers and accountants on Wall Street. And they can participate in the creative ferment that generates the best ideas. New York will specialize in cutting-edge jobs, says Saskia Sassen, a University of Chicago sociologist, that require "evaluative judgment, inferring, guessing, forecasting, making the most of what you don't really know."

SILICON ALLEY. New York's future specialties will be not only in finance but in consulting, accounting, health care—and technology, a field in which New York is often underestimated. Already, the New York area has a larger communications and computer services workforce than any other major metro area, according to the Citizens Budget Commission. And the Silicon Alley boom of the 1990s created a network of New York venture capitalists able to take advantage of the next tech upturn.

Though Silicon Alley is severely shrunk from a year or two ago, "we still have a better, more vibrant VC community than we did in 1999," says Fred Wilson, managing partner of Flatiron Partners, a tech venture-capital firm. Adds Bruce Bernstein, president of the New York Software Assn.: "Silicon Alley could be a motor of rebuilding, just like we were a motor for the city's growth during the '90s."

That is for the future. Over the next year, New York's fate partly hinges on the national economy and the stock market. Intensely specialized regions like New York and San Francisco are more vulnerable to economic downturns.

RETAIL BLUES

More layoffs, fewer tourists are dealing stores a one-two punch

What Propelled New York's Growth

CHANGE IN EMPLOYMENT	1991-2000
MOTION PICTURES	120%
SECURITIES INDUSTRY	42%
MANAGEMENT CONSULTING, ACCOUNTING, AND ENGINEERING FIRMS	38%
RESTAURANTS AND BARS	34%
PERIODICALS	31%
HOTELS	28%
CONSTRUCTION	22%
PRIVATE UNIVERSITIES AND COLLEGES	21%
HEALTH CARE	20%

.....And What Didn't

LOCAL GOVERNMENT	-3%
TELEPHONE COMPANIES	-7%
MANUFACTURING	-21%
DEPARTMENT STORES	-24%
INSURANCE COMPANIES	-25%
BANKS	-34%
TOTAL EMPLOYMENT	10%

Data: Bureau of Labor Statistics



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con Valley depend on exporting their products and services to the rest of the country and, indeed, the world. That makes them more vulnerable when there's a national or global downturn. American Economics Group, a Washington-based consulting firm, calculates that even if the terrorist attack had not occurred, New York City, because of its mix of jobs, would have lost 2.5% of its employment in the current downturn, vs. a loss of 1.8% for the nation as a whole.

The city's last dark age, in the early and mid-1970s, coincided with stagflation, followed by a deep national recession and a bear market on Wall Street. From 1969 to 1977, the city lost 600,000 jobs, a sixth of the total. Then, after a decade of strong growth, the city fell into another slump, from 1989 to 1993, when it lost nearly 400,000 jobs.

URGENT NEEDS. Today, the city's economy is more closely tied to cyclical industries such as finance, media, and advertising than ever before. In particular, employment in the securities industry rose 42% from 1991 to 2000 (charts, pages 100 and 101). In 1999, the latest year for which data are available, Wall Street accounted for 17% of the city's payrolls. So a long slump would hit New York harder than the rest of the country.

If the problems of New York's industries are strictly cyclical, then a return to rapid growth of the national

economy would quickly benefit it. But there are troubling signs that New York's anchor, the securities industry, faces deeper problems (page 120) than merely the current bear market. For years, New York-based brokerage firms have racked up enormous profits—and paid enormous bonuses—by control

the underwriting of stock and bond issues and dispensing vice on mergers and acquisitions. Now, commercial banks are trying to muscle in. The market-share war is eroding margins and forcing cuts in payrolls, which account for about half of investment banks' costs.

Right now, New York City's most urgent needs are to rebuild its damaged transportation infrastructure downtown and to plug a gaping hole in the city budget. Mayor Rudolph W. Giuliani has frozen hiring and is asking many city agencies to trim as much as 15% from their spending to close a gap in a budget that until recently was expected to be in surplus. On Oct. 9, Giuliani and New York Governor George E. Pataki asked Washington for \$54 billion in incentives, tax breaks, and subsidies beyond the \$17.5 billion granted

THE RAT RACE

Commuters—some New Yorkers could imagine working elsewhere

Cuts in the city budget will only exacerbate middle-class flight

A woman with long blonde hair, wearing a light-colored top and sunglasses, is sitting on a wooden deck. She is working on a laptop. In the background, there is a large globe showing the Americas. The scene is set outdoors, with a wooden railing and some foliage visible. The overall tone is warm and professional.

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It didn't escape the world's notice that the stock exchange was back in business within a week

month. But they'll probably get only a fraction of what they're seeking. Further cuts in parks, schools, sanitation, and other services will make the city a worse place to live, exacerbating the flight the city is trying so hard to arrest.

Should the rest of the country worry about what happens to New York City? Yes, for several reasons. The city is a powerful generator of federal tax revenue, for one thing, typically sending \$9 billion a year more to Washington than it gets back in aid. More important, the world-class products and services that emanate from New York City—from TV shows to advertising campaigns to books to intricate new financial instruments—might be a bit less world-class if the city loses its critical mass. That's a case New York State Comptroller H. Carl McCall is trying to make. "There would be so much

New York City loses far more people to other parts of the U.S. than it gains from domestic migration. The nearly 5% loss in the late 1990s was the biggest of any major city, according to Census Bureau data. Taxes are a big factor. Families earning more than \$100,000 a year pay far higher taxes in New York than in any other major city, according to the Citizens Budget Commission. And relatively few wealthy families send their children to public schools.

"VERY RESILIENT." Of course, those factors have existed for years. The new challenge is terrorism. Believers in New York's future say cities have rebounded from far worse than the World Trade Center attack. Columbia University economists Donald R. Davis and David E. Weinstein point out in a new research paper that Japanese cities recovered quickly

after the U.S. bombing in World War II, and, moreover, that the biggest cities stayed the biggest, regardless of how bad the damage. New York's own financial district recovered from a fire in 1835 that leveled 700 buildings around Wall Street.

Terrorism differs from those disasters because it is an ongoing threat. Still, New Yorkers don't seem ready to quit. "We are a very resilient people," says Brooklyn-born Richard Parsons, co-chief operating officer at AOL Time Warner Inc. The gall New Yorkers showed in the aftermath of the Twin Towers attack—including the opening of the New York Stock Exchange just six days later—impressed the world. "That's just pure brain and pure muscle," says Paul O'Connor, executive director of World Business Chicago, an economic development outfit. Although O'Connor makes a living recruiting businesses to move to Chicago, he says, "there's nothing on earth like New York City."

In the end, the September 11 attack probably did tip the balance in New York toward dispersion and away from agglomeration. Some analysts say dispersion is not only inevitable but healthy. "New York is going to become more multipolar," says Los Angeles. It will find out it can't shove everything into an area as dense as possible and think that it's going to work," says Joel Kotkin, a professor of public policy

at Pepperdine University in Malibu, Calif., and author of *New Geography: How the Digital Revolution is Reshaping American Landscape*.

Fair enough. But even the suburban real-estate executives who are trying to lure businesses away from Manhattan agree that New York City—like the sun—must continue to have a white-hot center. "We only exist as a function of New York," says Edward Tonnessen, executive vice-president of Albert B. Ashforth Inc., a commercial real estate firm in Stamford. The essential city will go on, as it must.

With Michelle Conlin, Louis Lavelle, and Spencer Ante
New York and bureau reports



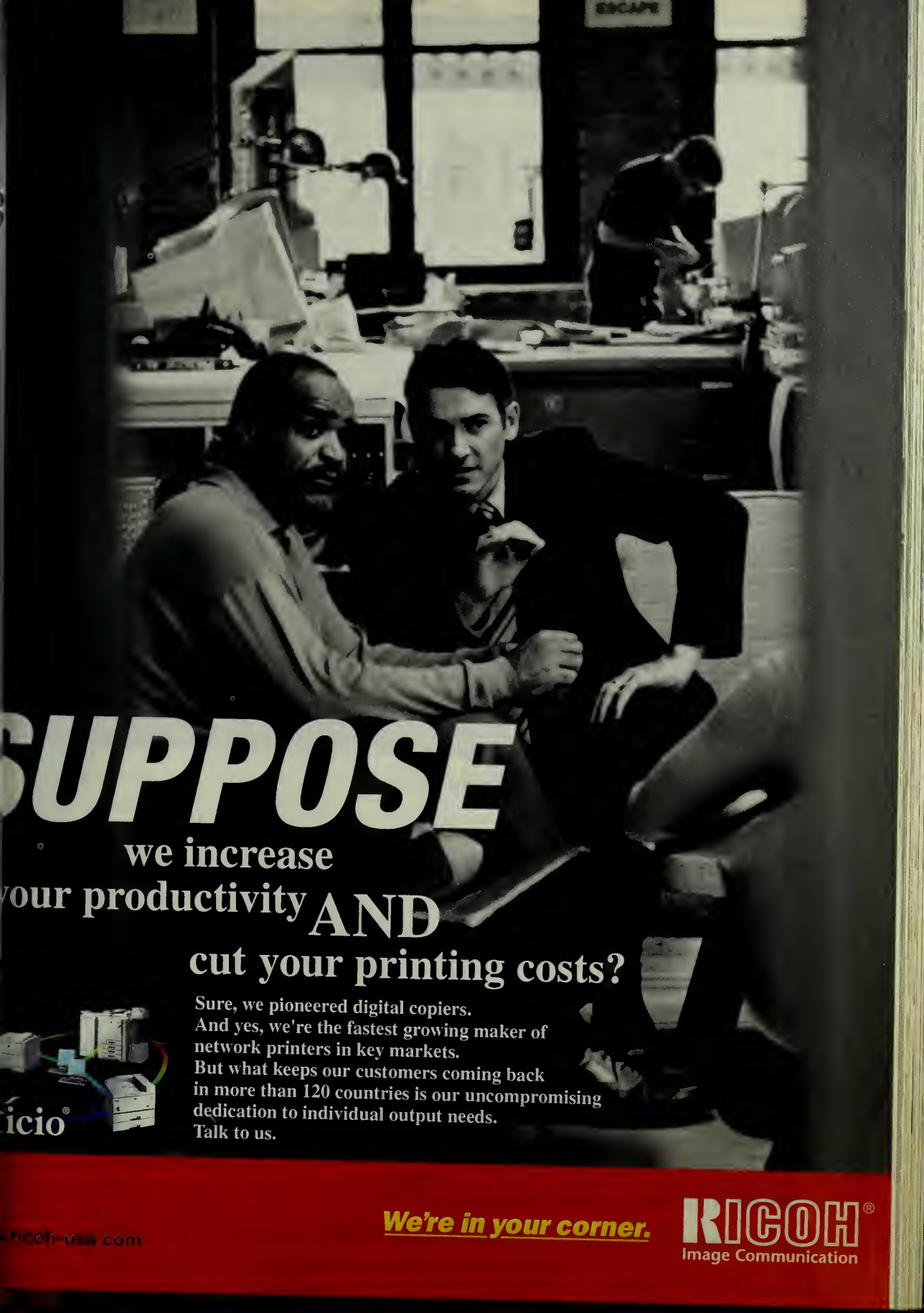
dispersion that these industries would be less effective. They would become so scattered they would lose their impact," he says. "That is a very important issue for New York and the country."

In fact, the feared flight of business has already begun. Even companies like American Express Co. that remain committed to Manhattan are moving parts of their staffs to New Jersey, Westchester County, N.Y., and Connecticut. Some are doing it temporarily because their offices were damaged or destroyed, but others are signing long-term leases. On Oct. 8, Morgan Stanley Dean Witter & Co. announced it would sell a nearly completed office tower in midtown Manhattan rather than make the building its new headquarters. Although Morgan Stanley will remain based in New York, several thousand employees will be moved out.

The suburbs and beyond remain a powerful lure for many New Yorkers. While the city's population grew in the 1990s, it was due mainly to immigration from abroad. In spite of popular stories about bright-eyed newcomers from Kansas,

WALL STREET

Tighter security is raising costs and eating up people's time



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How Big a Blow To the Budget?

Even with federal aid and spending cuts, the city is facing big deficits

■ BY DAVID HENRY

It took a quarter of a century, but New York City officials had pulled off a turnaround for the ages. From its 1975 brush with bankruptcy and descent into a national symbol of urban blight, the city became a model of clean municipal finance. Buoyed by bull market tax revenues, the city that once required a federal bailout was consistently balancing its budgets.

That was before September 11. Now, Mayor Rudolph Giuliani estimates the city will lose \$1 billion in revenues this fiscal year—including a 20% decline in personal income taxes and more than 30% declines in hotel and real estate transfer taxes. Added costs for additional police overtime, downtown cleanup, and other services will soar into the billions. And big union contracts expire starting at the end of June.

The bottom line is that even with help from Washington, New York is staring at a budget deficit of \$4 billion in the fiscal year beginning next July, more than 10% of current spending. Says Charles Brecher, research director at Citizens Budget Commission, a not-for-profit fiscal monitor: "You've got big spending pressures coming, and now revenues are going down. It doesn't look good."

To make matters worse, New York was still footing the bill for its last recovery effort. Officials more than doubled the city's debt since the last recession to fund what has become a never-ending effort to upgrade school buildings, roads, and other infrastructure neglected during the 1970s. Even before



September 11, debt service was running at a high 15% of revenues, up from 11% in 1990, according to Fitch IBCA bond-rating service. Few would argue with the need for capital spending. But the city was using its boom-time revenues to cover annual operating expenses. That's like a household counting work bonuses to pay the electricity bill.

CRUNCH TIME. Now those extra monies are vanishing. First was the bust on Wall Street, then a stalling national economy and now this. It all adds up to a crippling situation for the mayor, who will be elected on Nov. 6. The winner will take as resources dwindle and citizens voice demands for a penny. Worst case: The city has to scale back services, such as garbage pickup and aid to the homeless, or hike taxes, chase away employers and tourists. "From our long-term rainy point of view, the question is what people and business will be staying in the city and reinvesting," says Fitch analyst Richard J. Raphael.

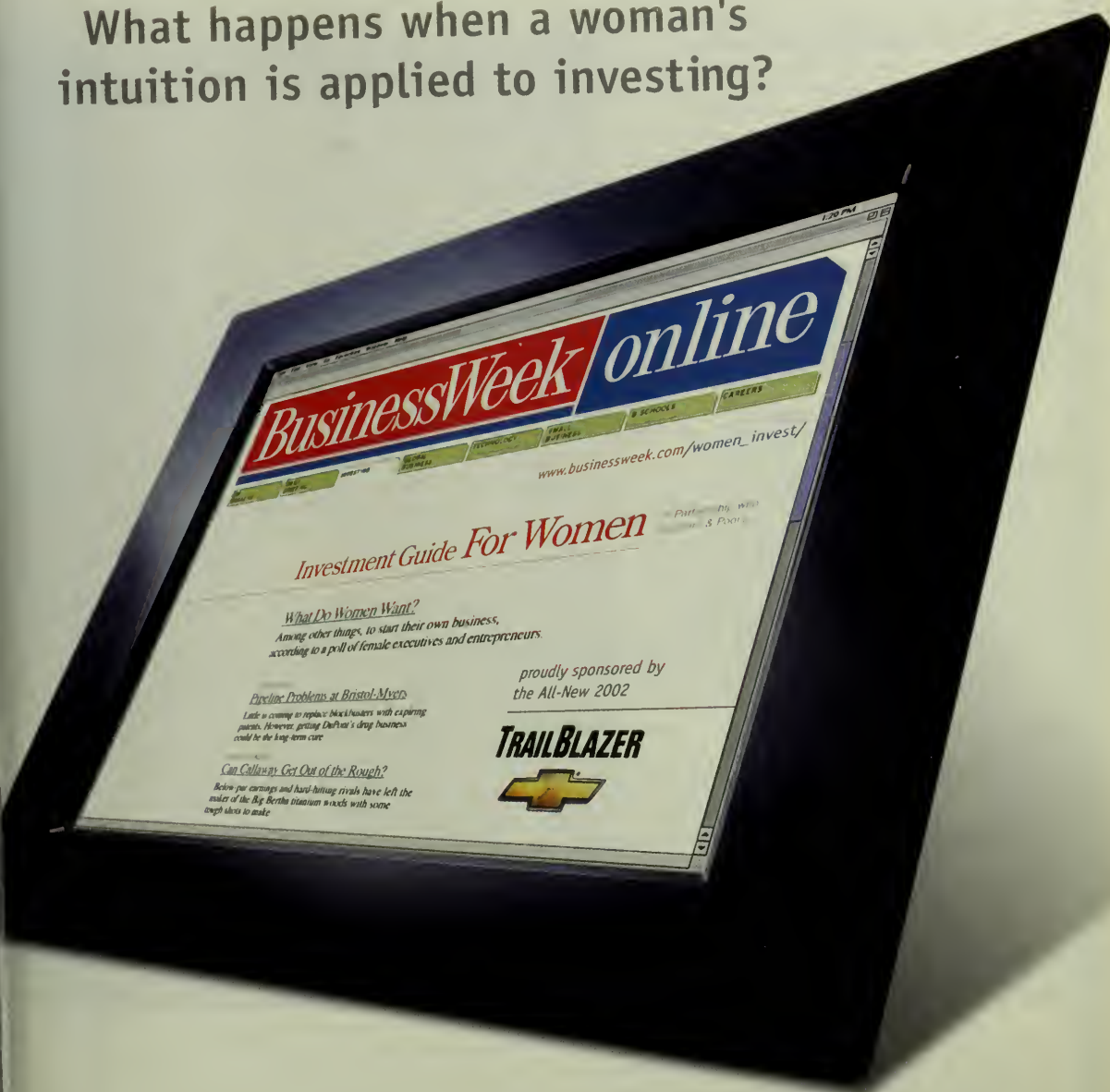
The immediate issue will be keeping the budget for the current fiscal year in balance. Under laws set up after the 1975 crisis, when investment banker Felix G. Roatyn worked with Mayor Abraham Beame and others to skirt a financial

WORKOUT

Roatyn (left) and Mayor Beame during the city's brush with bankruptcy in the

First it was the bust on Wall Street, then the stalling national economy—and now this

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If taxpayers begin to flee, a city already awash in debt could find it hard to borrow more

down, the city must end each year within \$100 million of its budget or risk losing control to a state authority. As a practical matter, the budget—now \$39 billion including federal and state funds—must be balanced to keep access to the capital markets. The city has balanced it for the past 20 years.

Now, officials will have to scramble to uphold that record. On Oct. 9, Mayor Rudolph Giuliani told a room packed with city and municipal-bond-market officials that city agencies would have to cut \$1 billion from their spending plans. Uniformed services, such as police and fire, and the board of education are

fiscal problems in the past, Giuliani says, including crunches in 1994-95 when Wall Street and the real estate market were suffering from the bust at the end of '80s.

But things will get gloomier next July. That's because this year's budget is using up most of a \$2.9 billion surplus left over from the roaring '90s. "Clearly the city is going to have a tougher time with next year's budget than they thought it would," says Colleen Woodell, credit analyst at Standard & Poor's. And Washington is already wary of an expanded commitment. Indeed, Governor George Pataki is going beyond

Giuliani's reimbursement request and asking for \$54 billion. Says Assistant Senate Minority Leader Don Nickles (R-Okla.): "We have a lot of money for New York in the pipeline right now. Let's see where that goes."

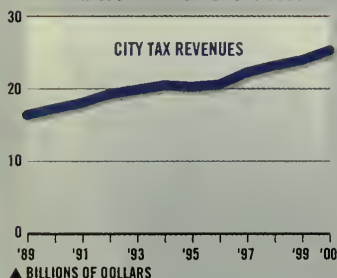
So far, all three major debt-rating services are sticking to their investment-grade opinion of city debt, figuring that regions hit by natural disasters tend to get a short-term boost from rebuilding. City bonds are in such demand that they are trading at yields only a few percentage points above AAA-rated municipal debt, New York's lowest level in several decades, says Michael Roberge, a portfolio manager at MFS Investment Management. Much of the appeal is due to New York City's hard-won goodwill from investors for its relatively clean accounting.

SOUND MANAGEMENT? But if taxpayers begin to flee, New York could be caught in a downward spiral, making it hard for a city already awash in debt to borrow more. Indeed, the city has nearly tripled since 1990, from \$11.8 billion to \$33 billion as of December. In addition, \$11 billion of debt is still outstanding from Municipal Assistance Corp., the entity created in the 1970s to give the city time to pay its bills. Add in capital lease obligations, and city indebtedness is \$40 billion—or \$4,800 per capita, the highest in the nation, according to the city comptroller.

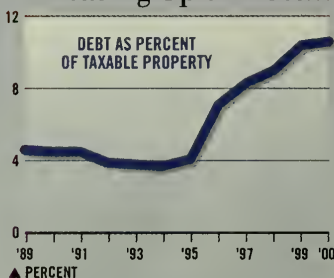
Why did New York let its debt grow so fast during the fat years? Giuliani insists it was sound fiscal management, and that debt market rates were staggered so that just 26.5% of the surplus would be used to pay down debt. "We're not bankrupt," the mayor says. But critics say New York should have paid more of its rebuilding costs out of its annual budget. "It makes sense, given the constant and intense wear and tear on city structures. Also, paying more along the way would have increased costs and left more leeway to borrow as a last resort." Now, the city will likely have to scale back its capital projects. Victims may include desperately needed new classrooms, as well as subway-line extensions and parks. As the patriotic cheer for New York dies down, city officials will face the grim reality of having to do more with less.

With Steve Rosenbush in New York and Lorraine Woelke in Washington

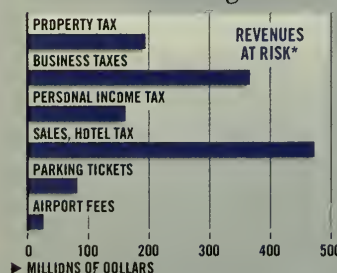
The City Bounced Back in the '90s...



...Even As It Was Loading Up on Debt...



...But Now its Budget Will Take a Big Hit...



*ESTIMATED REVENUES LOST FROM ATTACKS, FISCAL YEAR '02 AND '03

Data: NYC Office of Management & Budget, Office of the Comptroller, Finance Dept.

...Putting the Squeeze on New Projects

PLANNED CAPITAL EXPENDITURES

School construction	\$15.7 billion
Subway and buses	\$1.4 billion
East River bridges	\$1.1 billion
Water tunnel	\$652 million
Court complex	\$598 million

getting preference, having to cut their budgets by only 2.5%. Other agencies will have to cut 15%, and some are likely to offer severance packages to reduce payrolls. Those numbers assume that the federal government will reimburse the city for \$11.4 billion in expenditures Giuliani says are directly related to the attack, such as \$5 billion for emergency construction at the World Trade Center site, and \$3.8 billion for police, fire, and health services. Congress has approved \$20 billion in aid for New York, Virginia, and Pennsylvania.

The situation would have been even more dire had the city not estimated revenues conservatively last spring. Even then, Giuliani planned on profits plunging 75% in the securities industry, a major source of taxes. He was also expecting a 6% decline in corporate profits. "We've faced significantly worse"

due over the next five years. If the city had used its surplus to pay down debt, it would be short of cash now and "near bankruptcy," the mayor says. But critics say New York should have paid more of its rebuilding costs out of its annual budget. "It makes sense, given the constant and intense wear and tear on city structures. Also, paying more along the way would have increased costs and left more leeway to borrow as a last resort."

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With Steve Rosenbush in New York and Lorraine Woelke in Washington

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Rebuilding the City Underground

Transporting throngs of workers downtown is a huge undertaking, but it's critical

■ BY NANETTE BYRNES

The top of the World Trade Center's 110-story towers, its visitor's deck, may be what travelers from around the globe remember most. But to the hundreds of thousands of locals who passed through the complex every day, what really mattered was the basement. That's where one of the city's key transit hubs drew in 77,000 commuters every workday from New Jersey, plus hundreds of thousands more who rode the subway lines that ran through it. While most of the discussion about how to rebuild Lower Manhattan focuses on the structures above ground, the future of those below-ground transit lines is just as crucial to the financial district's recovery.

Indeed, the disaster of September 11 gives New York the chance to build something much better. The web of stations and lines that served the Twin Towers had been cobbled together from train lines dating back a century. The result was far from ideal. Rebuilding could lead to more modern telephone lines, state-of-the-art power stations, and better road access. Best of all, new train lines could mean faster service for downtown neighborhoods and better connections with existing lines. With billions being promised for rebuilding, long-ignored ideas, such as an additional train tunnel beneath the Hudson River and the Second Avenue subway, are getting new life.

Even with substantial aid, rebuilding will be a daunting task. Just replacing the infrastructure that was lost—the 300,000 telephone lines, the two electrical power stations, the network of streets—will cost billions and probably take the better part of the decade to complete. “Of the manmade environments, Manhattan is easily the most complex,” says Columbia University historian Kenneth T. Jackson. That, says Jackson, “makes it the ultimate city, but also vulnerable to interruption.”

BIG AMBITIONS. It's an environment a long time in the making. New York understood early on that a strong backbone would be key to its ambitions to attain world capital status. At the turn of the century, when few cities were thinking much beyond paving their roads, New York was already building a massive reservoir system to bring mountain water to its citizens and digging the tubes that would house what



continues to be one of the most extensive subway systems in the world. Indeed, New York remains one of the few U.S. cities where life is perfectly possible without a car. “New York has always had a sense of its destiny as the greatest city in the world and wanted to have an infrastructure befitting that,” says John D. Landis, a professor of urban planning at the University of California at Berkeley.

Lately, though, New York has been surpassed in infrastructure spending by rival areas. Northern New Jersey has put billions into new train and subway lines in the past decade. The result, says Robert E. Paaswell, director of the City University of New York's Institute for Urban Systems, is an area that's “as attractive a place to develop as the tip of Manhattan.” Already, many displaced Wall Street firms have signed leases across the Hudson.

If New York hopes to remain the center of world finance, it will have to move quickly. Right now, Lower Manhattan is operating on what Consolidated Edison describes as “36 miles of extension cords.” But plans to rebuild are afoot. Arthur Imperatore, president of NY Waterways, the largest private ferry owner, has hopes to build terminals capable of handling 60,000 to 80,000 New Jersey commuters for \$70 million. The Empire State Transportation Alliance is pushing several initiatives. E. Sander, one of the group's chairs, says it's time to throw support behind the Second Avenue subway line, aimed at bringing traffic south from Midtown. Manhattan's future has always hinged on its ability to get workers on and off the island quickly, cheaply, and comfortably. That's just as true at the start of this century as it was at the last.

BIG JOB

Now the city has a chance to build a more efficient transit network

Tallying the Toll

Here are early estimates on what it will cost to get just the basic infrastructure back in place downtown

	BILLIONS
Replacing destroyed subway lines	\$3.0
Utility repairs, including 300,000 telephone lines, 1 phone switching station, and 36 miles of electrical cable	2.0
Rebuilding PATH New York/New Jersey station below the World Trade Center	2.4
Total	7.4

Data: New York City Office of the Comptroller



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COMMENTARY

By Robert McNatt

Memo to the New Mayor

Between now and Nov. 6, you candidates will be battling it out for what has been called the second-toughest job in America. When you joined this race a year ago, running New York City looked a lot easier than it does now. Today, New Yorkers are rattled by the World Trade Center attack, an economic slump, and looming multibillion-dollar budget deficits.

Let's be blunt. You don't want to be remembered as the mayor whose arrogance or incompetence made things worse. So here are a few pointers for the winner.

■ **Make Nice with Albany.** No question, relations between the city and the state have traditionally been strained. Upstaters, who are mostly Republican, often think of the city as a Democratic sinkhole for state funds and a place decent people go only for the occasional Broadway show. Moreover, even

governors and mayors of the same party can end up on opposite sides of an issue: Witness Mayor Rudolph Giuliani and Governor George Pataki, who have feuded for years over funding for a proposed \$1 billion stadium in Manhattan.

So keep repeating after me: *Governor Pataki is my friend. Governor Pataki is my friend.* Why? Because your first priority will obviously be rebuilding the World Trade Center area. Both the land on which it stood and the destroyed rail lines beneath it are wards of state or bi-state agencies, so the Governor can veto any design for a new structure to occupy the site. If you're looking to expedite rebuilding by skirting local zoning or environmental reviews, you will need state consent. And, most important, the federal government will probably distribute its aid through the state, not the city.

In short, much of the final decision-making power will lie in Albany. It helps that Pataki's "fortunes are tied up in how well New York City does," says former New York City Mayor David N. Dinkins. And don't forget: Pataki is up for reelection next year and he surely will work hard to maintain his newfound popularity with voters.

■ **Washington Is Not an Endless Source of Funds.** Tread carefully when you ask the New York congressional delegation to hit up the Feds for more money. Any hint that the cash will be used to fulfill campaign promises instead of rebuilding will go over as well as ordering pastrami with mayonnaise at the Carnegie Deli. Anti-New York bias lingers inside the Beltway. Before Congress granted \$17.5 billion in emergency aid last month, Senator Don Nickles (R-Okla.) balked because his state didn't receive the same level of aid, proportionately, after the 1995 Oklahoma City bombing. Senator Charles Schumer (D-N.Y.) sees the fiscal writing on the wall: "With the economy turning down, lots of people have demands." It will only become harder to get yours met as the national economy worsens.

■ **The City Will Do as Well as the People You Pick To Run It.** The two most crucial appointments you'll make will be the budget director and police commissioner. Whoever takes over the city's finances will have to contend with a deficit of at least \$4 billion for fiscal 2003. "During times of austerity, that's when the rubber hits the road for the budget director," says E.J. McMahon, a senior fellow at the Manhattan Institute for Policy Research. When you renegotiate contracts with municipal workers, tie raises to improvements in their productivity. At the same time, don't skimp on such highly visible services as sanitation.

WARTIME ALLIES

Governor Pataki and Mayor Giuliani were bonded by history, but New York and Albany have long been at odds over budgets and ideology.



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WHAT WILL NOT CHANGE

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Morgan[△]Stanley

and park maintenance. But do try to spread the pain evenly.

Make sure your top cop continues the successful policies of the past eight years. It will be especially important to crack down on the quality-of-life offenses that make New Yorkers feel the city is out of control. And if you find someone who can do this while improving relations with black and Latino residents, keep him around. Don't pull a Rudy: He hired the talented Bill Bratton, saw a steep decline in crime—then fired the guy.

■ **Remember that the City Is Not Just Manhattan.** Rebuilding on the World Trade Center site is certainly the main issue. The attack immediately put at risk 108,500 jobs citywide, including 20,100 in the financial services industry, according to the Fiscal Policy Institute. But the fact remains that most voters don't live in Manhattan. They may work there, but they go home to neighborhoods without enough affordable housing, whose schools are in bad shape, and whose parks are tattered. There will be no greater task than to balance the needs of those communities with the imperative to revitalize lower Manhattan, and to do so during a money crunch.

■ **Finally, Keep New York United.** Giuliani may be wildly admired now, but he hasn't always been. He won office in 1993 with little African-American support, and he never found a way to connect with the city's black populace. He ignored black political leaders and mishandled incidents involving the police and black New Yorkers. The damage was lasting: In early October, the Mayor floated the idea of extending his tenure beyond the legal limit of two terms. Fully 55% of all New Yorkers supported that, but 82% of black residents polled objected.

You can establish better rapport. To do so, you'll have to solicit the opinions of various groups before you make important policy decisions. "The quality the next mayor will need the most is the ability to build consensus," says Arthur J. Fried, executive director of the Center for Excellence in New York City Governance. Since the attacks, New Yorkers' spirits, if not their politics, have been united. If you want to be a great mayor, make sure your administration builds on that newfound sense of community.

With Lorraine Woellert in Washington, D.C.

COMMENTARY

By Gerry Khermouch

Fix NYC. The Region Will Follow

The scope of the World Trade Center disaster—and the inflow of capital that will help repair the damage—is prompting a sweeping evaluation of New York City's future. It's also spurring hope that, at long last, New York and surrounding areas might begin to tackle problems from a regional perspective. Suddenly, there's no time to waste waging beggar-thy-neighbor development wars between

those happen, says Robert D. Yaro, executive director of the Regional Planning Association.

Other ideas that have bubbled up since September 11, from dispersing more of New York's white-collar jobs to other boroughs to crafting regional development compacts, don't belong to the agenda. Creating alternative business centers within New York "is not of primary importance now," says



New York and New Jersey or squabbling among the city's five boroughs over resources and jobs. Now that the attacks devastated land and rail lines operated by the Port Authority of New York & New Jersey, the region's foremost planning entity is set to play a key role in reconstruction.

JUST A DIVERSION. But history, practicality, and the need to rebuild downtown New York as quickly as possible make lofty talk of a breakthrough regional approach a diversion. "That rhetoric makes me nervous at a time that needs a more concrete approach," warns Michael Slattery, vice-president for research at the Real Estate Board of New York Inc. The focus must be on the downtown business district. It's only when that area is restored to vibrancy that other regional goals should be taken up.

Sure, some regional plans have a chance of success. Long-sought transit projects, such as an expanded Secaucus, N.J., transit hub or a Hoboken-Lower Manhattan-Brooklyn link, would benefit both the region and the financial district. Despite the worsening fiscal climate, a new sense of urgency could muster a consensus to make

FERRY COMMUTERS

Now is not the time for plans to disperse jobs throughout the boroughs

Kathryn Wylde, president of the New York City Partnership & Chamber of Commerce. Using federal relief funds outside lower Manhattan could backfire. Congressional support for aid "could evaporate very quickly if this turns into some kind of economic development engine" for all of New York City, Slattery says.

Most pie-in-the-sky is a hope that a coordinated regional approach would end New Jersey's and other rivals' seduction of businesses away from high-priced Manhattan. True, development officials around the country are backing off for now. For the longer term, even advocates for New York argue that governments shouldn't influence where businesses locate. Forget about the big picture. New York needs to make rebuilding Lower Manhattan Job No. 1.

Associate Editor Khermouch often writes about urban planning.



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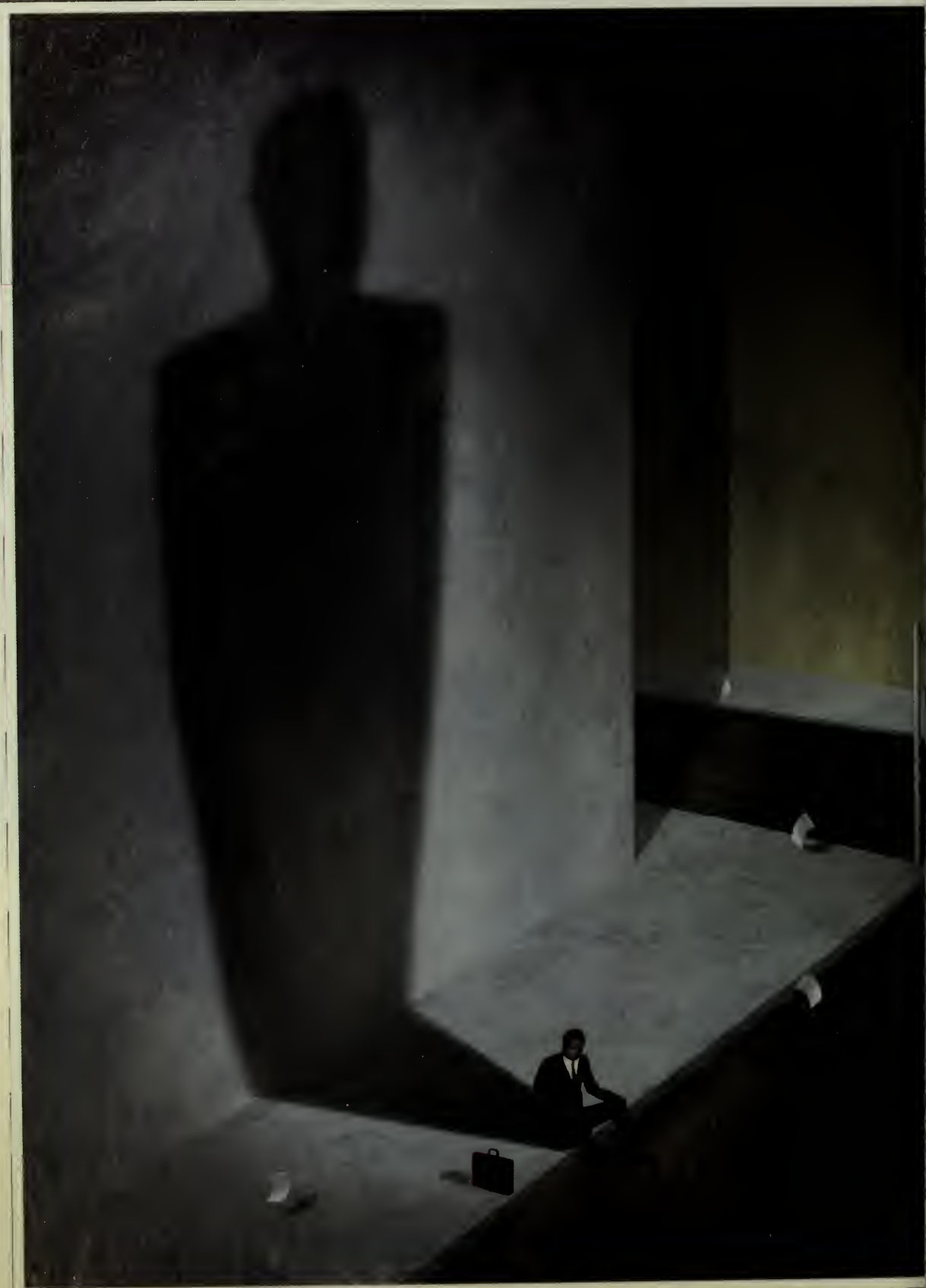
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Wall Street: The Big Chill

shakeout and hard times loom as the golden market after another rises up and old reliables falter

BY EMILY THORNTON

Richard S. Fuld Jr. is not sure how long the recession will last. But the chairman and chief executive of Lehman Brothers Inc. does know that he will have to move most of the staff who used to work at the firm's former headquarters next to Ground Zero into a new 32-story skyscraper in midtown Manhattan he will buy from rival Morgan Stanley Dean Witter Co. for about \$700 million. And he's certain how much the business on Wall Street has gotten since September. "We were already headed into a recession," Fuld says. "Mergers are way down, initial public offerings are way down, and financing markets are down."

Wall Street will never be the same. In time, the devastation in New York's financial district will be repaired. But then, many firms will likely have dispersed—uptown, out Manhattan to other boroughs, or to neighboring states. What's more, the way Wall Street works will change. Gone is the gilded age of excess fired by a global infatuation with the stock market. A humbled financial-services industry will have to scrape by on a sparser diet of lower-margin business and far fewer deals. At the same time, it must learn to rebuild its credibility, shattered by overinflated stock prices, rosy-spectacled stock recommendations, and charges of fraud and interest.

A dramatic shakeout is at hand in the \$600 billion financial-services industry. Investment and commercial banks, brokers, asset managers, and mutual-fund companies will all have to cut costs to survive the drop in business. That means staff cuts. Investment banks will be particularly hard hit. They are still staffed for boom times, with payrolls accounting for about half of their outlays. Credit Suisse First

Boston plans to prune \$1 billion of operating expenses next year, 70% of it by cutting 7% of its 27,500 employees. "We face a far more severe economic environment than anyone imagined prior to the tragedy," Chief Executive John J. Mack told employees. Even so, CSFB's head count will be one third higher than when it bought Donaldson, Lufkin & Jenrette last year. Goldman Sachs Group Inc. may cut 400 people in October. It now has 23,000 employees, vs. 14,000 in 1999. And Morgan Stanley could lay off 10% of its 2,000 investment bankers.

As the pain spreads, the pressure to build new financial behemoths on the lines of Citigroup will grow. More than ever, commercial banks—including foreign ones—are trying to make inroads into high-margin investment-banking businesses such as advising on mergers, arranging IPOs, and asset management. Weaker firms are being pushed to the wayside as the number of deals dwindles and clients flock to the players with the deepest pockets. "You'll know the big game is on when we see transcontinental, trans-industry mergers, and they will be in the \$100 billion range. That is going to be the endgame. And we're about there," says Philip J. Purcell, chairman and CEO of Morgan Stanley.

With more firms fighting over fewer opportunities, power is shifting to clients. Companies such as Ford Motor Co. are playing investment banks off against commercial banks by offering commercial lenders a crack at lucrative investment-banking deals and asking investment banks for credit lines to keep that business. In the process, they're undermining Wall Street's cozy cartel, which exacts fees as high as 8% for IPOs and 3% for mergers, according to Thomson Financial Corp. "I'm ready," says Beth Acton, vice-president and treasurer at Ford. "Many corporations have been looking at their overall investment-banking and commercial-banking relationships recently."

FALLEN STARS. Whatever happened to the Masters of the Universe? They rode the equity culture for all it was worth. But they were thrown when the high-tech bubble burst. And now they're floored by the rush of investors and companies to safe havens such as bonds. Even before the attacks, the financial system was under duress. Banks were wobbling under a pile of bad loans that had doubled in a year, to \$192 billion. Hedge-fund stars such as George Soros and Julian H. Robertson Jr. had self-destructed. Mutual-fund in-

vestors had lost their appetite for equities. And online brokers were limping from the dramatic fall in trading, while traditional brokers were struggling to make profits from the dirt-cheap commissions they had to offer to compete.

Angry investors and corporate clients turned on Wall Street with a vengeance—slapping investment banks with lawsuits that could cost up to \$5 billion to settle. The Securities & Exchange Commission and the U.S. Attorney's Office launched a major investigation into possible irregularities by banks and brokers during the great IPO boom. Ben Coes, chairman of Cambridge (Mass.) software startup Beachfire Inc., is bitter that investment bankers took his fledgling company public last year even as the Nasdaq market went into steep decline. "Bankers and venture capitalists were doing something that ultimately was not good for the economy," he says. "Was their advice good? No."

Today, the downdraft is even worse. September 11 accelerated the economic slowdown and left Wall Street panting through a business drought that some executives fear might last up to three years. Right now, investment banks are hanging on by issuing bonds, which have lower margins, or trading. But even that revenue could sputter out should the markets be numbed by terrorism. If that happens "it will get ugly," warns Henry McVey, securities industry analyst at Morgan Stanley.

Commercial banks, their earnings sagging from write-offs on loans and venture-capital losses, are racing to contain billions of dollars of exposure to airlines, insurers, and hotel chains. And hedge funds, which usually shine in crises, lost money in September, even if they beat the Standard & Poor's 500-stock index. "If there is a long recession that lasts for a year, you'll see [the financial-services] business really change," says CSFB's Mack.

BULKING UP. Propelling the industry down this path is a group of hard-charging bosses with an insatiable appetite for deals. According to Wall Street's conventional wisdom, commercial banks that have already morphed into giants could try to finish off traditional brokerages and investment banks. HSBC Holdings CEO John Bond has snapped up two American companies, Republic Bank of New York and Safra Holdings. And he won't rule out a future bid for No. 1 brokerage Merrill Lynch & Co. Deutsche Bank, which made a run at J.P. Morgan last year before it fell into the arms of Chase Manhattan, can pay for deals in shares after listing on the New York Stock Exchange on Oct. 3.

Investment banks—especially the larger ones—also

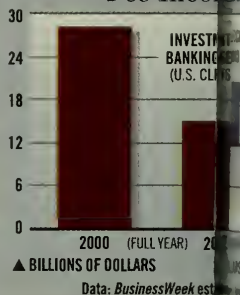
Wall Street Woes



High-Margin Business
Plummets...



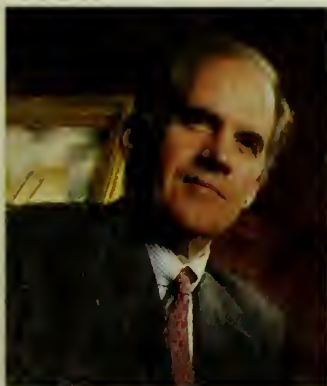
...Dragging Down
Fee Income



want to bulk up. Morgan Stanley's Purcell is mulling a string of deals to strengthen the firm's ability to raise capital and advise big clients such as pension funds from Tokyo. Frankfurt. In the U.S., he's eyeing money managers and retail brokers. Goldman Sachs Chairman and CEO Henry "Hank" Paulson wouldn't mind picking up a money manager either. "We're always looking for something that adds value," Paulson says.

The fault lines between the strong and the weak are widening as companies and big investors such as mutual funds and insurers become choosier about whom to rely on for advice. "If you don't see one of the top few investment bankers on a deal, you have questions right off the bat," says John W. Skornicka, co-manager of Invesco Financial Services Inc. So investment banks are shaking up management teams, axing nonessential investments. Within three weeks of the takeover, Merrill Lynch's new president, E. Stanley O'Neal, pointed new heads to run the firm's four core businesses.

Keeping employees motivated will be tough. Compensation consultant Johnson Associates figures investment bankers' pay will be at least halved this year. Senior bankers' compensation will probably tumble 80%. "Someone getting \$1 million will get \$1 million," says Alan Johnson, head of the firm. Bankers who survive the cuts may never again get multiyear guaranteed payouts they earned during the good days. For one thing, business on which they earn bonuses may not recover much. "Mergers and acquisitions and utility issuances could stay at this level or be 20% higher," says Michael Carpenter, head of Citigroup's Salomon Smith Barney corporate- and investment-banking unit. Best juggernauts will increasingly use teams to serve clients.

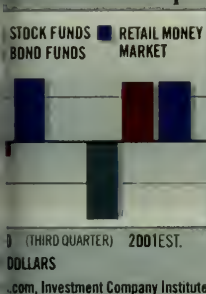


When Chase merged with J.P. Morgan, it was obvious a great many jobs would be cut—now 8,000 have gone

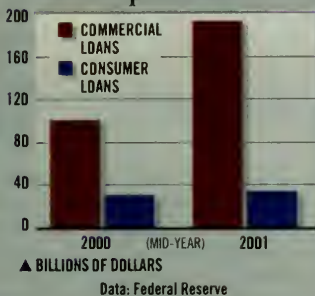
**J.P. MORGAN CHASE CEO
WILLIAM HARRISON**



Flow in Equity Funds Slumps...



...And Bad Loans Pile Up at Banks



ing no room for overpaid lone rangers. "It's over," says k. "There will be no more multiyear contracts at CSFB." he biggest threat still comes from the integrated megas. Citigroup's market capitalization at \$215 billion is four s bigger than that of the largest investment bank, Morgan ley (page 124). Besides, Citi and J.P. Morgan Chase—an- r behemoth built around a core commercial bank—aly account for over one in three of the world's mergers. they think it will be even easier to grab market share i investment banks during tough times. Along with other id banks such as UBS Warburg and Banc of America Se- ies, they're determined to carve out a larger chunk of the billion in fees Wall Street could earn this year by raising al for companies, down from \$26 billion in 2000. "We be- it's a huge opportunity," says John Costas, president chief operating officer of UBS Warburg. For example, Sa- on Smith Barney and others scored big points with ville's Gaylord Entertainment Co. on Oct. 5 by lending up 210 million on terms agreed on before September 11. t means a lot to me," says Gaylord's CEO, Colin V. Reed. l it will mean a lot when the times get good again." vestment bankers say they've beaten back raids on their ess before. But the commercial bankers are clearly ng them nervous: Investment bankers have started to back by extending credit to VIP clients themselves. ve taken that competitive weapon away," says Morgan ley's Purcell.

ommercial banks are eager to muscle investment banks use they face a raft of problems themselves. Many of iggerest banks are still working through high-price in- ent-banking acquisitions and trying to reduce ex-

penses. J.P. Morgan Chase has cut 8,000 jobs this year, 20% more than expected when it merged last September. "Mergers are about a certain redundancy," says CEO William Harrison. "Anytime you have an economic downturn, you have overcapacity."

Earnings growth at big banks is set to tumble sharply. Analysts predict their profits will rise only 4% to 8% next year, sharply down from 1999's double-digit returns. Many banks are saddled with more bad loans than they had in the 1990-91 recession, when some went to the wall. Today, analysts say, nearly 8% of \$1.56 trillion in outstanding credit-card debt, much of it backed by banks, could go bad in the next 12

DISPLACED

Lehman Brothers has set up temporary shop across the river from Manhattan

months. As a result, banks are having to increase loan loss reserves. For example, U.S. Bancorp alone took a \$693 million charge on Oct. 5.

Still, the giant banks insist they're sitting in the driver's seat because they have more capital now. "Like anyone with a com-

mercial-loan portfolio, we're expecting more losses," says Harrison. "But that's why you have capital. Our model has a huge advantage."

The same can't be said by online brokers. Large players, such as Charles Schwab & Co. and E*Trade Group Inc., also had ambitions to become one-stop shops for financial services. But those plans are being stymied by a drop in online trading. Consider Gordon L. MacPherson, president of a digital-video firm in Rockland, Mass., and an E*Trade customer since August, 1998. He used to make as many as 30 to 40 trades a day. Now, he makes at most one or two trades a month. "It doesn't make sense anymore," he says.

Now it looks more likely that many of the online crowd will be folded into the megabanks. Even Schwab has been forced to lay off 6,000 of its 26,000 staff, as its earning are expected to fall by a third to about \$465 million this year. Some analysts still believe the likes of American Express, J.P. Morgan Chase, or Wells Fargo could still buy E*Trade. Those that aren't acquired by larger players may have to merge with equally weak rivals.

FEE FALL. Money managers, too, look more vulnerable. Their fees have fallen along with the stock market and the value of the assets they manage. Savers are yanking money out of equity mutual funds—almost \$40 billion in September alone—and scurrying into bond and money-market funds, which earn lower fees. Big mutual-fund families such as Oppenheimer Funds, Janus, Fidelity Investments, T. Rowe Price, and Putnam are laying off employees, and some are nixing underperforming funds. But analysts don't think they're being aggressive enough. "Managers are not going to be able to cut deep or quick enough to offset the revenue fall-off," says

Big clients such as Ford have the chance to cut sweet deals by playing investment banks off against commercial ones

FORD MOTOR TREASURER BETH ACTON





Not only is Wall Street's geography changing, but several firms are revamping management

MERRILL LYNCH'S OLD HEADQUARTERS NEAR GROUND ZERO AND ITS NEW BOSS STANLEY O'NEAL

Glenn Schorr, senior analyst at Deutsche Banc Alex. Brown.

Some hope to find salvation on the acquisition trail. Eaton Vance bought Fox Asset Management and Atlanta Capital Management in October for more than \$107 million, while Legg Mason bought Royce & Associates for \$115 million and could pay an additional \$100 million based on performance. These deals may herald a wave of acquisitions of midsize firms that could engulf the likes of Bessemer Venture Partners and Neuberger Berman. But the shakeup "won't be limited to small fund complexes," says consultant Steven E. Bueller, national director of Asset Management Services at Ernst & Young.

But bulking up alone is no panacea. Wall Street's latest Holy Grail of creating conglomerates to provide all financial services to all people, along the lines of Continental Europe's universal banks, has lost some of its luster. "The challenge isn't why aren't we bigger, it's how with 20,000 people do we stay as special as we were with 5,000," says Goldman's Paulson.

Financial juggernauts that raced to be able to sell everything from equity to loans and insurance to credit cards are not home free yet. "Their greater diversification should have brought them greater stability," says Tanya Azarchs, financial-services analyst at Standard and Poor's. If it doesn't, "we could lower our ratings." Even mighty Citigroup, which has become so big that it considers itself in a league all its own, announced that it will have to take a \$700 million charge in the third quarter because of insurance and bank branch losses related to September 11.

Further signs of strain may ap-

pear if large numbers of companies start to default on loans. "The conglomeration has increased the amount of risk in the entire system," says economist Henry Kaufman of Henry Kaufman & Co. "It is difficult to understand the magnitude." Relationships forged between corporate clients and hybrid banks may chill. While corporate clients willing to let lenders provide strategic advice during the boom, they may not feel as comfortable if they have trouble paying back their loans. Swissair Chairman Mario A. G. is already accusing his bankers of a "conspiracy" that forced it to file for protection from creditors on Oct. 2. UBS and Credit Suisse deny it. "The whole episode is very serious," says a Credit Suisse spokesman. "But there was no conspiracy to hurt Swissair."

RIGHT STUFF. There's a chance that tough times will pressure Wall Street's firms to take big risks in hopes of boosting results. And if a global recession drags on, there is a danger that protectionism will rise, slowing the move toward market-driven economies, open trade, and pension reform on the part of the new behemoths dependent on their global expansion—and their future megadeals.

Instead of betting the bank on financial-services firms could turn themselves a favor by taking a critical look at their business models before cutting too deep on the coming compulsive shopping spree. "Tough times are times when you have to show what you're made of and perform," says Paulson. Only the firms with credit and the right stuff will survive the storm—and they'll be grateful on a lot less.

*With Heather Timmons
Mara Der Hovanesian in
New York and bureau reports*

Overshadowed

*Megabanks dwarf investment banks and brokers by market capitalization**

MEGABANKS BILLIONS		INVESTMENT BANKS AND BROKERS BILLIONS	
CITIGROUP	\$215	MORGAN STANLEY	\$55
HSBC HOLDINGS	97	GOLDMAN SACHS	40
BANK OF AMERICA	87	MERRILL LYNCH	35
WELLS FARGO	71	CHARLES SCHWAB	15
JP MORGAN CHASE	65	LEHMAN BROTHERS	14
UBS	55	BEAR STEARNS	8

*As of Oct. 9

Data: Bloomberg Financial Markets

"We must build a new world,
a far better world—
one in which the eternal dignity
of man is respected."

Harry S. Truman, 1945

We can think of no better way to honor the victims of the recent events in New York and Washington, than to dedicate ourselves to building a world in which such events are no more. A world of liberty, tolerance, and dignity for all people. As a start toward that goal, please join us in giving to the Red Cross. Or the relief effort of your choice. Thank you.





COMMENTARY

By John Rossant

New Yorkers of the World Unite

French Foreign Minister Hubert Védrine has at times been a prickly critic of the U.S., terming it the world's "hyperpower." But when it comes to New York, Védrine—like so many of his compatriots—is an unabashed devotee of the Big Apple. As soon as Védrine heard about the terrorist attacks on September 11, he rushed back to his offices along the river Seine and huddled, transfixed and horrified, around a television monitor.

His first thought was of his many friends in New York, and over the next hours, he and his aides frantically tried to telephone and e-mail Manhattan; only that evening would Védrine be assured that all, luckily, were safe and sound. "Watching those images of fire and airplane missiles, of bodies falling into the void, I thought back of all my trips to New York, almost twenty in the last twenty years," Védrine recalls. "In my head were all those walks, restaurants, parks, museums, galleries, films, the dog days of summer, the snow and the wind. I relived my arrivals in that city of cities, each time with the same emotion."

Everyone has two homelands, the incurable francophile Thomas Jefferson used to say: his own and France. A little over two centuries later, it could reasonably be said that every civilized European, probably every cosmopolitan citizen of the world, has two cities: his own and New York. No other

world city comes close to New York in combining financial might, cultural firepower, and sheer urban electricity. The whole world benefits from the resulting sparks. In petitioning Washington for massive federal aid for the city on Oct. 9, New York Governor George E. Pataki and Mayor Rudolph W. Giuliani underscored the importance of New York for the U.S. But New York is vital for the world, and there's no doubt how most Parisians, Londoners, and Berliners feel right now: Do what-

The feeling on the Continent: Do whatever it takes to bring the city back

ever it takes to bring the city back.

Feelings like that are one reason Mohamed Atta and his fellow hijackers couldn't have chosen a better target for maximum impact than the World Trade Center. They could have blasted those jets into a landmark in another American city. The country would have been savaged and the world appalled. But in some deep way, the attack on New York was an attack on the world. "The fact is that cosmopolitan people—especially younger people—in Paris or Frankfurt know

New York almost as well as they know their own cities," says French banker and philosopher Alain Minc. "You could argue there is more in common between New York and the cities than between New York and the American heartland."

It's hard, sometimes, for America to comprehend the almost mystical appeal New York holds for much of the rest of the planet. As a place where nationality largely doesn't matter, New York is for many a refreshing change from their own tradition-bound countries. "When we Europeans go New York we melt into the city, we are diffused into it," says Paolo Moroni, the head of Milan-based furniture group Sawaya & Moroni, who travels to Manhattan around four times a year. "Here in Europe, I remain an Italian if I go to France or Germany."

Moroni is confident New York will be able to get over this most painful episode in its history—he's already planning his next trip. For him, after all, as for so many other international business people, New York is the place where you most want your products be seen and sold. Védrine, too, is optimistic for the future of New York, "this power station of the world, where so many universal dreams are embodied," he says. It's not just America that needs New York. It's the world.

Europe regional editor Rossant covers European politics from Paris.



Todd Beamer

November 24, 1968 – September 11, 2001

From: Larry Ellison
To: All employees of Oracle Corporation

September 13, 2001

It is with indescribable sadness that I inform you that several of our people lost their lives in the terrorist attack on the United States. Todd Beamer lost his life when United Flight 93 crashed in Western Pennsylvania. Seven more are missing in the rubble that was the World Trade Center. We pray that some may be found alive.

We know Todd Beamer is dead. We believe he died when he and other passengers aboard Flight 93 tried to recover the hijacked airplane from the terrorists. In the struggle, the plane crashed. Todd's courageous actions may not have saved the lives of his fellow passengers, but he helped prevent the airplane from reaching its target – our nation's capital. Considering the devastation wrought by the other aircraft, it is unquestionable that Todd's brave actions, and that of his fellow passengers, saved countless lives on the ground. We are very proud of Todd. We will miss him. Our heart goes out to Todd's wife, and his two young children.

Seven other Oracle people are missing. Six of them are consultants that were working on the 97th floor of the South Tower of the World Trade Center. We have not given up hope. Rescue workers are still searching, so we will not reveal their names at this time. I will tell you that two of the missing consultants were from the United States, three were from India, and one from the United Kingdom. This terror and tragedy is reaching families around the globe. The entire civilized world is in mourning.

The last Oracle person missing was trained as an emergency medical technician. He was near the World Trade Center when the first airplane hit. When everyone else was running out of the building, he ran in. Like the police and firefighters, he risked his own life trying to save others. We will never know how many people he helped, or if he was able to save any lives. We do know that he ran into the building and died. In trying, he risked – and perhaps lost – his own life. Nothing is more heroic than giving your own life in an attempt to save another.

Several Oracle people are lost. Some we knew. Some we didn't. Some were heroes. All were family.

Larry

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THE GRIDIRON

SMALL-TIME FOOTBALL, BIG-TIME BUZZ

Now the NFL may buy into the Arena Football League

In 1959, Texas oilman K.S. "Bud" Adams Jr. forked over \$25,000 for the Houston Oilers, one of eight teams in the just-formed American Football League. Eleven years later, the AFL merged with the NFL, and in 1997, Adams moved his club to Tennessee and changed its name to the Titans. Today, with his franchise valued at over \$500 million, Adams, 78, has the buy-a-team bug again. This time, though, he's betting on a very different AFL.

The Titans' boss is among eight National Football League team owners who have bought into or plan to start up franchises in the Arena Football League. For most of its 15 years, the AFL has toiled well below the radar screen—not to mention the TV screen. But that looks to be changing. Attendance has more than doubled, to 2.6 million, in five years; plans are under way to have the AFL and af2 (its minor league) play in 100 cities by 2005—more than double the number of teams now; and Ford's truck division signed on last year as the first major corporate sponsor.

UNTAPPED TOWNS. More important, the NFL may take a piece of the action. At a meeting set for Oct. 30 in Pittsburgh, NFL owners will consider exercising an option for a 49.9% stake in Arena Football. NFL officials won't say what the stake would cost, but insiders figure the AFL is worth about \$60 million. "All the sports leagues are discovering that our second-line cities are untapped," says Mayor John H. Logie of Grand Rapids, Mich., home to an AFL team and minor-league hockey, baseball, and basketball.

In arena football, players use a regulation-size football, but the field is 50 yards long. Six of the eight players (11 in the NFL) must play both offense and defense. There's also more passing and scoring. In last year's ArenaBowl in Grand Rapids—at the end of the April-to-August season—the hometown Rampage beat the Nashville Kats, 64-42. Fans sit right up next to the field. "You really get to hear the crack of the pads," says AFL Commissioner C. David



COMIN' AT YOU;
100 teams by 2005?

Baker, a 6-foot, 8-inch, 385-pound lawyer. An average ticket costs \$17 for an AFL game vs. \$54 for an NFL contest. Players make \$40,000 to \$150,000 a year.

Still, the AFL can be a stepping stone to the big time. Arena Football's poster boy is quarterback and Super Bowl MVP Kurt Warner, who played for the Iowa Barnstormers (now the New York Dragons) before joining the St. Louis Rams.

The NFL, however, tends to see the AFL opportunity less as a chance to establish a minor league and more as a

brand-builder. Says Neil Glat, NFL vice president for strategic planning: "I look at this as a potential in our off-season to market and stay involved with football fans." It doesn't hurt that studies show a third of its fans are under 24, a red-hot demographic.

Even if the NFL takes a pass, the league has other plays in its book. Dallas Cowboys owner Jerry Jones, who is launching an AFL team in Dallas, is pushing arena football as an Olympic event. "This is the best chance we have to make football an international sport," says Jones, who holds the rights to launch a team in Monterrey, Mexico.

As Baker sees it, while the league concentrates on major markets, Arena Football will expand into both big and small cities. "The field is an inch wide and a mile deep," says Baker. "We are an inch deep and a mile wide." Two years after the AFL formed the af2 to establish teams in smaller markets, such as Wilkes-Barre/Scranton, Pa. An af2 franchise part-owned by Hall of Famer Johnny Unitas is set to launch off there next April. "You won't see spoiled guys out there," says Unitas, who once played for the Bloomsburg (Pa.) Rams. "These players are a bunch of local guys trying to get things done."

Underdogs sell, but "Let's face it, it's a miracle this league is here," says Casey Wasserman, owner of the L.A. Avengers and grandson of legendary Hollywood mogul Mervyn Wasserman. "The only reason we're here is because the product works."

Some 42 years ago, Bud Adams probably wasn't thinking about "the product" when he founded the Oilers. He just wanted a football team. Adams had no NFL experience, though. Critics kept questioning whether NFL fans loved football enough to follow a league called the AFL.

By Tom Lowry in New York

A Who's Who of New Owners

Famous names are buying into the Arena Football League



COWBOYS OWNER JERRY JONES
Dallas (unnamed; to start play in 2002)

HALL OF FAME QB JOHNNY UNITAS
Wilkes-Barre/Scranton Pioneers (af2 team; to start in 2002)

REDSKINS OWNER DAN SNYDER
Washington (unnamed; to start play in 2003)

EX-RAIDERS QB KENNY STABLER
Mobile Wizards (af2 team; to start play in 2002)

LIONS OWNER BILL FORD JR.
Detroit (unnamed; to start in 2003)

RETIRED BRONCOS QB JOHN ELWAY
Denver (unnamed; to start play in 2003)

COMPUTER ASSOCIATES CEO CHARLES WANG
New York Dragons (Long Island)

FORMER EAGLES QB RON JAWORSKI
Philadelphia (unnamed; to start play in 2003)



Data: Arena Football League

"no"

"can't"

"NEVER"

"WON'T WORK"

"That's dumb"

"No way"

"Give up"

"Impossible"

Ahh, music to our ears.

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SHORT" FUNDS

BusinessWeek Investor

'The Biggest Wake-Up Call Of My Life'

After the attack, a shift in plans

BY MICHELLE CONLIN

Just minutes after the first tower collapsed, Maurice Matsumori was crouching in a pitch-black, dust-smothered lobby just yards from the World Trade Center, unable to erase from his mind the horror he'd just seen: guys his age, dressed in suits and ties—guys who had probably just finished their morning coffee, like he had—falling from windows 100 stories high. He wondered if they died doing the jobs they loved.

If he had been in the building that day, Matsumori knew his answer to that question would have been no. Sure, he still felt like a high roller every time he got a direct deposit on his nearly \$75,000 salary—double what his buddies in his native Salt Lake City make. But now, he walks to work through a war zone and smells death all day long. In contrast to the groaning hell of Ground Zero visible out his window, his job as a quality-control specialist at AIG—where he helps the bottom line more than people—has lost much of its pre-Sept. 11 meaning. He used to flirt with the idea of becoming a college professor. Now, he's made the commitment, enrolling in school to get a PhD in education—small salary be damned. Says Matsumori, "This was the biggest wake-up call of my life."

It's a call being heard beyond Wall Street. Across the U.S., white-collar workers are firing up their PowerPoint presentations and piping into conference calls, only to realize that what was bearable before September 11 has become intolerable since. Watching firefighters, police officers, and politicians do work that seems so vital, these disaffecteds are shredding their play-it-safe plans and considering doing what they've always dreamed of but were too scared to try.

"Pants, jeans—it's just not it for me," says Marcy Scott Lynn, 29, who two weeks after the attacks quit her job as a corporate-communications manager for Levi Strauss & Co. in San Francisco, even though she had only had it for five months. Growing up, she watched her mom become bronze-handcuffed to a dental company job she loathed. Lynn is now seeking a public af-



fairs job while she figures out a way to build a career teaching kids how to be savvy consumers of the news and analyzers of current events. "I don't want to die wishing I had chosen something that meant more," she says.

DAUNTING OBSTACLES. As noble as such motivations sound, career experts caution against making impetuous changes during emotionally charged times—unless, like Lynn, you're young, single, and mortgage-less. For one thing, people don't walk away from secure positions to pursue idealistic dreams without the requisite bankroll to find the financial insecurity so psychologically uncomfortable that it consumes them, leaving little time for creative pursuits.

They also face daunting obstacles: a rapidly declining economy, badly battered stock portfolios, and an ever-worsening job market. Even in war, people still have to eat and pay the mortgage. Dissatisfied workers also face the risk of glamorizing alternative careers—that, without careful homework and planning—could be as disillusioning as the jobs they leave. "Panicked business decisions usually don't work out very well," says Kenneth Lloyd Encino (Calif.)-based management consultant and career counselor.

If you're contemplating a major shift, it helps to have a job lined up—if only a temporary one—before you tell your current employer you're quitting. Short of that, you should have at least a year's worth of living expenses set aside so you can think through your next move and put a plan in place, says Marti Smye, management consultant and author of *Is It Time to Run Away and Join the Circus?* (Crown, \$14.95).

Jeffrey Henning figures that by dipping into his savings and stopping the accelerated





FIRE INSIDE

Taborga isn't content being a financial analyst

TRAGIC LESSON

Matsumori had a narrow escape. Now, he'll go after a PhD in education

on his mortgage, he and his family can live year while he tries to build a new software company from home. Henning, 33, waited three months after the terrorist attacks before he told his partner that he wanted out as chief operating officer of Perseus Development, the Braintree, Mass.-based software maker they founded nine years ago. He could no longer tolerate the 60-weeks in pursuit of the now-evaporated dream that someone would buy them out for millions. "I missed way too many of my kid's recitals," he says.

ST MOVES. For those who don't have the time or money to take such radical steps, experts advise modest moves, ones many are already taking. Candidates who were in the job recruitment pipeline before the disaster, for example, may be refusing jobs that require long commutes, include a lot of flying, or have offices in disaster-prone areas. You may be able to make changes in your current job, such as arranging to work part-time or part-time—leaving you more time to work you really love.

Whatever changes you're considering, it helps to have a sounding board. Career experts advise creating a personal "board of directors" composed of family members, friends, those working in industries you're interested in, and trusted business associates. Run your ideas past them to get honest, unvarnished input.

You should also do research before plunging into any new situation. Career coaches have a variety of psychological tests, such as Meyers-Briggs, that can sort out what skills you'd be happy using. They also advise giving new ideas a road test by volunteering in the field at a minimum, talk to people who already do the kinds of jobs you want. How do you like them? Who they are? Notice whom you envy. That's why 34-year-old Nico Taborga, a finan-

cial analyst for Cohen Financial in San Francisco, has been talking to a lot of firefighters lately. After the attacks, he sat in his bland, windowless cube, unable to muster any enthusiasm for the property substitution deal he was working on. He felt more of a sense of community in the line to give blood than he did in his macho, me-first office. An iron man who loves being on teams, he found himself wanting to join with the firemen as he watched them on TV. "It just hit me so strongly, right in the chest," he says.

Taborga realizes he may never end up becoming a firefighter, but he's leaving his job anyway in a quest to find more meaningful work. "At least I'll be trying to find and pursue my dream," he says. Recently, he and a friend were talking about their tombstones. "Financial analyst" is one thing Taborga wouldn't want engraved on his. ■



ADIOS, LEVI'S

"Pants, jeans—it's just not it for me," Lynn says

Before Uprooting Your Career

- Run your ideas by trusted family members, friends, and business associates
- Create a plan for your next move
- Test-drive new careers by volunteering and talking to people in the field
- Have a year's worth of savings to fall back on
- Avoid making radical changes out of panic or fear

Data: Marti Smye, Right Management Consultants, Personnel Decisions International

Taking the Edge Off Getting the Ax

When layoffs strike, stay calm—then negotiate



BY CAROL MARIE CROPPER

Even before September 11, more than 1.5 million American workers had been hit by mass layoffs this year. Economists say things are likely to get worse. But if the employer's scythe finds you, don't feel you are powerless. There are strategies you can use to walk away with the best possible financial deal, and with your professional reputation intact.

Just understanding that a firing is a negotiable transaction helps you avoid the biggest mistake workers make, says Steven Sack, a New York employment lawyer and author of *Getting Fired* (Warner Books, \$7.99). "They bow their head and shuffle their feet out the door," he says. Yet even in a weak economy, you have leverage. Companies don't want to be sued by irate ex-employees. They don't want the kind of mean-spirited image that makes it harder to recruit in good times. And they don't want morale to plummet among remaining employees who see their colleagues hustled out the door.

True, severance packages will likely become less generous as corporate profits plunge. And in mass layoffs, it will be tougher to convince the boss to single you out for better treatment. But exceptions are made. Richard Bayer, chief operating officer of the Five O'Clock Club, a career-counseling and outplacement firm, points to a client laid off three months after moving across the country to take a new job. Reminding supervisors that his wife had just quit her job to follow him, he appealed to the company's sense of fairness and won more cash and additional career counseling. Your mantra should be, "I just want to be treated fairly," says Bayer.

First, remember that the ego-bruising firing session is a time to keep quiet. Don't become hostile or threaten to sue. Don't insist you're

resigning instead. Don't try to gain. Unless you knew the firing was on the way, you will be emotionally off-balance and in a poor position to negotiate. Listen, perhaps even take notes. "The trick is not to act pissed and angry," says Sack. "You want to appear to corporate decency and fair play."

Avoid signing anything that day. Instead, ask for everything in writing and schedule a follow-up meeting. Say so-

thing like: "You know, this is a shock. I need some time to think about it, and I'll get back to you." Most companies will agree to that, says Sack. In fact, if you're aged 40 and over, federal law requires an employer to give you 21 days (45 days in the case of a mass layoff) to consider the package before signing a waiver or release. **MOVING OUT.** One thing to ask during the follow-up session is how and what other employees will be told. If you're a manager, perhaps you'll want to break the news to your staff yourself. Whatever you say should not conflict with the story the company will use as you look for work. If you plan to tell prospective employers you lost your job, the company cut middle managers to save money, don't tell others you got canned because you didn't get along with your boss.

Also, ask when you can remove your belongings. Civility will often buy you the benefit of waiting until others have left, or of returning to work. "There's nothing more humiliating than being laid off and having to go into your office and pack up with everyone watching," says David Birkel, who founded the Professionals in Transition Support Group after going through two layoffs. Also ask if you'll be able to check your mail and have e-mail forwarded.

After you leave the initial meeting, seek advice from books and articles—or from an employment lawyer. Your local bar association



Remember: The most valuable thing you'll take with you is your professional reputation

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help you find one. Review the company handbook for benefits promised. If other employees were laid off, ask those you know what kind of deal they got. By the time of your return meeting, you should understand the company's offer and know what is important to you.

For many, the most valuable items will be the cash severance and outplacement services. Even in good times, it can take one month for every \$10,000 a year a worker earns to find a comparable job, says Sack. Try asking for a month's salary for each year you've been with the company—keeping in mind that two or three weeks per year is more typical. If you're let go near the end of the year, see if the company will pay part of the money the following year to avoid a big tax bill while you're out of work. As for outplacement, decide if having use of an office is as important to you as coaching from a career counselor. You might want to ask for additional counseling in return for a shorter stay at the outplacement center, or for cash to buy the services you need.

VACATION TIME. Since keeping you on the company health plan costs little compared with severance payments, you may find flexibility here. Three months, six months—even a year—might not be out of the question. Ask if the company will continue covering you on its group plan rather than simply making the payments for you under COBRA, the federal law giving workers the right to continue health coverage at their own expense. That way, you'll still be eligible for 18 months of coverage under COBRA after the company insurance ends.

Make sure you'll be paid for unused vacation and comp time and get an accounting in writing. If your company pays a yearend bonus, ask for a prorated amount. If you're close to vesting in a pension or stock options, see if the company will

keep you on the payroll until it happens. If Securities & Exchange Commission or pension rules stand in the way, try to negotiate a settlement for the options instead. For this, you might need an economist or pension actuary to calculate a fair value, says Hempstead (N.J.) employment lawyer Robert Rosenthal.

Through all this, remember: your most valuable thing you'll take away is your professional reputation. Negotiate the kind of reference you'll receive, and get it in writing. If your former boss loved you, the new taskmaster thought you were incompetent, list the earful you gave on applications. Call or send thank-you notes to those who have agreed to give references, outlining the job strengths you played a part in. If all else fails, ask your boss and company personnel manager to just confirm your dates of employment and your title to prospective employers.

Don't resign. Getting downsized

is easier to explain than quitting without a job, says Sack. Plus, unless you get a side agreement from the company promising not to corner your unemployment benefits or deny severance, that bit of pridefulness can be costly. On the other hand, the alternative is having your boss tell you you were fired for cause or poor performance. Should you consider resigning instead of letting the company fire you, advises Sack. Even then, try to get an agreement allowing benefits.

Employees don't have to be caught as sleeping on the job. Guard this time as they were in the early '90s, when white-collar layoffs were a new phenomenon. In 1993, when R.J. Reynolds bacco axed 1,200 workers, it never occurred to John Colthar, a North Carolina computer programmer, that he could ask for a better deal. Now, as he watches his new employer go through a merger in an economic slowdown, he says he won't be so naive if there's a next time.

Web Resources

SITE (WWW.)

EQUAL EMPLOYMENT OPPORTUNITY COMMISSION eeoc.gov

Help in filing discrimination claims

FORTNEY & KLINGSHIRN
myemploymentlawyer.com
Info and advice from employment lawyers

NOLO.COM
nolopress.com
Describes rights of employees losing or leaving a job

U.S. DEPT. OF LABOR dol.gov
Info on unemployment benefits, health insurance under COBRA



Appeal to corporate decency and fair play when getting fired: You can ask the company for extended health care coverage and a prorated bonus

If a Layoff Is Lurking...

■ **PREPARE FOR THE WORST** Update your résumé and check in with your professional network. Take home the company manual outlining severance benefits and make copies of any positive evaluations and contact info you may need.

■ **SAY LITTLE ON THAT FATEFUL DAY** Don't sign anything. Instead, ask for the terms of any severance package in writing and schedule a time when you can return to discuss them.

■ **SEEK ADVICE EARLY** Talk to an employment lawyer or read up on the subject. Deciding you were treated unfairly after you sign an agreement may be too late.

■ **BE PREPARED TO NEGOTIATE** Try to get the best deal on severance pay, outplacement help, health coverage, bonus, retirement benefits, and stock options. Make sure you'll get all the vacation and comp time pay you're owed.

■ **PROTECT YOUR REPUTATION** Negotiate what kind of reference you'll get, then get it in writing. Avoid resigning. If you feel you must, get a side agreement entitling you to unemployment benefits and severance.

Should You Spend Fortune on Your MBA?

Our calculator figures what a degree might be worth

BRIAN HINDO

Skittish about giving up \$100,000 and two years of your life for an MBA degree? Should you choose a cheaper, public university or a pricier, more prestigious private university? How long will it take to recoup your lost income and tuition? Well, it all depends. BusinessWeek Online's exclusive Return on Investment Calculator can help you estimate what sort of payoff to expect from that sheepskin.

Start at www.businessweek.com and click on "B-Schools." Under the header "Getting In," click on the "ROI Calculator." First, choose the B-school or schools you would like to attend. Plug in your salary, gender, home state, years of work experience, current employer's size (number of employees), and undergradu-

ate major and career plan (consulting, investment banking, or other).

To help you decide on an MBA program, the ROI tool will churn out personalized statistics: the amount of money you'll have to invest (including lost income); your estimated salary increase; and how many years it will take to recoup the investment through salary increases. Finally, the calculator racks up 10 years' worth of estimated salary increases and, from that vantage point, figures an annualized rate of return on the money you spent.

Much of the calculation depends on where you are now and where you plan to go. For example, more work experience correlates with a larger salary. Consulting and investment banking are more lucrative career paths than, say, working for a nonprofit. Whatever your stats, the ROI

calculator can estimate how degrees from various schools might pay off in the long run.

Say, a New Jersey woman with five years of work experience for a big corporation earns \$65,000 a year and wants to do consulting (table). Between

the University of Pennsylvania's Wharton School and local Rutgers University, her better option is the top-ranked Wharton MBA. She'll invest almost \$50,000 more at Wharton than at Rutgers, but the estimated salary increase a Wharton degree provides more than makes up for it. She recoups her initial outlay 4½ years sooner and earns a higher salary to boot. The Rutgers MBA won't let her break even for 11 years.

Depending on your situation, attending a public university can save you more than any salary increases you would get from attending a prestigious private school. Consider a New Jersey man with three years at a small company, earning \$40,000, and also shooting for a career in consulting. For him, the Rutgers option might be better. He would get a higher salary from Wharton, but his investment is a third less at Rutgers. Net result: a 31.9% ROI for Rutgers, vs. 26.7% from Wharton.

To be sure, the ROI calculator makes estimates based on data the B-schools provide, and every MBA student's experience differs. The calculator doesn't measure such intangibles as the value of learning for learning's sake or creating a network for future job opportunities. Although a Top 10 B-school might not pay off with your first post-MBA job, the network you create could open doors later on.

Still, the calculator offers insight into whether that MBA is worth it. For instance, if your pre-MBA salary is \$80,000 and you want to work in consulting, only two B-schools—Harvard Business School and Stanford University—would give you a positive ROI over 10 years. In that case, you may be better off investing your money somewhere else. Then again, considering the stock market these days, maybe you do want to invest in yourself.

YOUR CAREER



How To Use the BusinessWeek's ROI Calculator

BusinessWeek Online: B-Schools ROI Calculator

University of North Carolina at Chapel Hill (Kenan-Flagler)
 Eastern University (Kellogg)
 Case Western Reserve University
 Duke University (Max H. Fisher)
 Pennsylvania State University (Smeal)
 University of Pennsylvania (Wharton)
 University of Pittsburgh (Catt)
 University of Michigan (Ross)
 University of Virginia (Darden)
 University of Wisconsin-Madison (MBA)
 University of South Carolina (Darla Moore)
 University of Southern California (Marshall)
 Methodist University (Cox)
 University of Maryland (Smith)
 University of California (Berkeley)
 University of Tennessee
 University of Texas (McCombs)

1 Select any or all of the B-schools listed in this window. If you don't select one, the calculator will run the stats on all 64 programs.

2 Fill in vital statistics about yourself, such as salary, gender, and work experience. The more complete your answers, the better the results will be. Hit the "Calculate" button at the bottom of the screen.

3 The calculator will show your investment in dollars, salary increases, breakeven period, and annualized return on investment over a 10-year period. They are ranked by ROI.

Salary: \$65,000 (annual)
 Size of most recent employer:
☐ Fewer than 5,000 employees
☒ More than 5,000 employees
 Undergraduate major:
☒ Business
☐ Non-business
 Career plan:
☒ Consulting
☐ Investment Banking
☐ Other
 Work experience: 5 years

School name	Investment (in \$1,000s)	%	Salary Increase (in \$1,000s)	Breakeven (in years)	Annual ROI (10-year basis)
University of Pennsylvania (Wharton)	160.0	36.7	6.9	11.0%	
Rutgers University	132.1	14.2	11.3	None	

You Can Sit On Two Stools

"Long-short" funds play on rising and falling stocks

BY LEWIS BRAHAM

There were more bears in last quarter's top-performing mutual-fund list than in the Moscow Circus. Profunds Ultrabear, Prudent Bear, Rydex Ursa—all these are "short" funds that soar when the stock market swoons. The problem with these funds, however, is you have to get out when the bulls start to stampede. That's why a better alternative may be the "long-short" funds that also are high on the recent mutual-fund hit parade. Such funds as AXA Rosenberg Value Market Neutral and Boston Partners Long Short Equity profited

fees, little regulatory oversight, and illiquid

Since hedging practices vary, the funds not all alike. For instance, Phoenix-Euclid Market Neutral Fund buys stock of companies that have low price-to-earnings ratios and high revenue growth and sells short the high p-e, low-growth stocks in the same industry. So, portfolio manager Carlton Neel holds New York Times, which he thinks is undervalued, and has a short sale of Dow Jones, which he considers overpriced. That kind of pairing puts investment research to good use. If Neel is right on both companies, he can make money as Times rises and Dow Jones falls. Such pairing across many industries also neutralizes broad market moves. AXA Rosenberg Value Market Neutral has a similar strategy. Both are up sharply in 2001 (table).

Calamos Market Neutral takes a different approach. It buys the convertible bonds of a company and shorts the underlying stock. The fund owns Lucent Technologies convertible bonds yielding 8%, and has a short position in the stock. In a bear market, the short position makes money. The convertible bond declines in value but not as much as the common stock. An ad-

kicker to the investment is the income from the bond. In the past 11 years, the Calamos fund made money only once—in 1994, a lousy year for the bond market.

DOUBLE PLAY. Other long-short funds are not market neutral. They take bets on the long and short sides. That's riskier but can lead to higher returns. Managing Edmund Kellogg of Boston Partners Long Short, a value-oriented fund, is bullish on energy stocks and bearish on housing. "Historically, housing stocks trade between 0.5 to 1.5 times book value," he says. "They recently went up to 1.7 times, though the weakness in the housing market. His fund is up 20.7% this year because he favors cheap stocks. Invesco Advantage and Gemini Global New Economy, which are long-short funds but lean toward pricier growth stocks, are down 24.9% and 27.6%, respectively.

Such sophisticated strategies are costly. Boston Partners' fund, for instance, has a 2.75% expense ratio—nearly higher than the 1.41% average for U.S. equity funds. One reason is the extra cost of running two portfolios, one long, the other short. Another is that these funds must pay dividends on the stocks they've borrowed to establish short positions. That can add as much as 0.4 percentage points to the expense ratio, experts say. The extra costs are not unreasonable considering that traditional hedge funds charge 1% of assets plus a 20% cut of investment profits. In a bear market, paying for protection may be worth it.

Funds That Hedge Their Bets

FUND (SYMBOL)	TOTAL RETURN*	
	2001	3-YR.
AXA ROSENBERG VALUE MKT. NEUT. (BRMIX)	23.8%	0.2%
BOSTON PARTNERS LONG SHORT (BPLEX)	20.7	NA
CALAMOS MARKET NEUTRAL (CVSIX)	6.3	12.9
CGM FOCUS (CGMFX)	8.3	39.9
GEMINI GLOBAL NEW ECONOMY**	-27.6	NA
HUSSMAN STRATEGIC GROWTH (HSGFX)	9.5	NA
INVESCO ADVANTAGE (IADAX)	-24.9	NA
JAMES MARKET NEUTRAL (JAMNX)	1.9	2.5
LEUTHOLD CORE (LCORX)	-11.3	7.4
MONTGOMERY GLOBAL LONG-SHORT (MNGSX)	-28.0	14.1
NEEDHAM GROWTH (NEEGX)	-2.2	37.3
PURISIMA TOTAL RETURN (PURIX)	8.0	17.2
PHOENIX-EUCLID MARKET NEUTRAL (EMNAX)	9.5	2.8
QUAKER AGGRESSIVE GROWTH (QUAGX)	-6.5	36.6

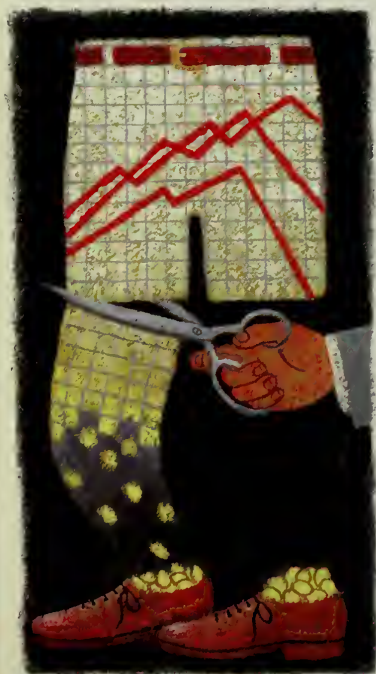
* Appreciation plus reinvestment of dividends and capital gains before taxes. 2001 results through Oct. 8. Three-year results are average annual.

** No ticker symbol. Go to www.geminifunds.com for more information.

Data: Morningstar Inc.

handsomely. Since they bet on some stocks rising in addition to falling, their results are impressive in a down market.

These hedged funds are not too different from hedge funds, the exclusive province of investors with at least \$1 million in assets or annual income of \$200,000. Unlike regular hedge funds, which can boost returns through buying on margin, these funds can only leverage their assets by 30%. So their upside potential is not as great as conventional hedge funds, but the downside is more protected. They also don't have hedge funds' many drawbacks, which include high



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THE NERVOUS RUSH TO MUNIS



BY ROBERT BARKER

rb@businessweek.com

There's one good reason to buy munis now: You're not strong enough to stomach steep losses on stocks

Are you thinking of swapping some stocks for bonds? This is on a lot of people's minds. For the first time since 1998, municipal-bond funds are taking in more cash than investors are pulling out. Bob Santoro, a veteran Charles Schwab branch manager in Vero Beach, Fla., sees these kinds of moves up close. And he's suddenly noticing not just retirees, or people preparing to retire, but also fortysomething clients growing conservative amid the bear market. "There's this little thing in the back of their heads now: What if this lasts a lot longer?" he said.

Truly, there is no single, right answer to how much of your portfolio should be in stocks and how much in bonds. But if you're eager to lower your risk, I have two suggestions. First, get to the bottom of why you feel this way. Second, if you do find yourself in the market for bonds, shop thoughtfully.

Both are easier said than done. To be buying bonds now, when most yields are at lows not seen in years, implies one of three motivations. The first two—panic over money that has been lost on stocks or a belief that deep recession and yet lower yields lie ahead—strike me as foolish. No one trades wisely while panicking, and few people successfully predict interest rates. The third reason, a calm admission that you mistakenly saw yourself as strong enough to stomach steep losses on stocks, is the only one that makes sense.

If you're admitting that most basic mistake, then be careful as you look for bonds. Investors in the 28% or higher federal income-tax bracket (since July 1, the new rates run 27%, 30%, 35%, and 38.6%) have become used to seeing better



aftertax yields on more than on comparable corporate or Treasury bonds. But with high demand pushing muni yields down, that rule is in flux, says Vanguard Group financial planner Jack Brod. Vanguard's intermediate-term muni fund pays 3.8%—equivalent of 5.2% to investors in the 27% bracket. Its intermediate-term corporate bond fund now yields 6.1%. That's 4.5% after taxes for an investor in the 27% bracket.

As it happens, long-term munis right now are offering the best balance of risk and return. The average yield on 30-year Treasury munis recently came to 96.5% of the 30-year Treasury bond's yield, while

year munis yielded less than 88% of what year Treasuries paid. The sweet spot, according to Paul Disdier, Dreyfus' director of tax-exempt securities, is in the 13- to 15-year range, where investors get the most yield for the risk.

STEADY. Buying munis directly, though, is not most people. Unless you have at least \$500,000 devoted to your own muni portfolio, plus the patience to run it and reinvest the interest, you're better off using mutual funds. Closed-end funds can be a good choice when they trade at steep discounts, but that's not the case now. The Herzfeld, a closed-end specialist in Miami, says only gets tempted when they trade at discounts of 15% or more. "My guess is you won't see that until December," he said, when tax-related trades often cut prices.

That leaves the more familiar open-end mutual funds. With advice from Morningstar's bond-fund analyst, Eric Jacobson, I searched among the hundreds of muni funds (not counting those focused on a single state's bonds) for steady performers with low fees and no load. I found four with portfolios full of longer-term bonds (table) worth considering.

One caution: As interest rates rise, long-term bonds fall more in price than do shorter maturities. If interest rates rise one percentage point, for example, these funds would lose about 8% value, while comparable intermediate-term funds would sink 5% and short-term muni funds 3%. And before you invest in any bond fund, member first to examine why you are anxious. If you are clear that the bear market has taught you something about yourself, don't forget the lesson whenever the bull does return.

Muni Bond Funds: Four Favorites

FUND/ SYMBOL	TOTAL RETURN*		EXPENSE RATIO	PHONE (800)
	2001	5-YR		
FIDELITY SPARTAN MUNICIPAL INCOME FHIGX	6.8%	6.8%	0.48%	343-3548
T. ROWE PRICE TAX-FREE INCOME PRTAX	6.1	6.2	0.55	638-5660
USAA TAX-EXEMPT LONG-TERM USTEX	5.6	6.1	0.37	382-8722
VANGUARD LONG-TERM TAX-EXEMPT VWLTX	6.7	6.6	0.18	662-7447

*Appreciation plus reinvestment of dividends and capital gains before taxes.

Performance data through Oct. 3. Five-year returns are annual averages

Data: Company reports, Morningstar Inc.

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ways. But we are a people
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nation are beyond measure.
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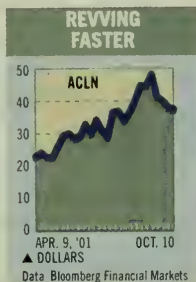
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fon's defense
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Investors are on the lookout for stocks unaffected by the September 11 attacks. Many companies have warned they will miss their sales and earnings targets. One that seems to be immune so far is ACLN (ASW), which ships low-cost used cars from Europe to Africa. Management expects to meet analysts' estimates for the next quarter and for all of 2001, but some pros close to the company think ACLN will exceed expectations for the September quarter as well as for the years 2001 and 2002.

"ACLN's story is an ideal growth and value play," says David Jordon of Axiom Capital Management, who cites the company's growth rates for the past five years: sales up 37% a year on average, and operating earnings up 77%. Gregory Burns of J.P. Morgan Securities expects ACLN to earn \$4.75 a share in 2001 and \$7.05 in 2002, vs. 2000's \$2.93. "The company has seen no disruption in business following the attack," he says. In fact, orders have increased. Africa's demand for low-cost cars, says Burns, should not be diminished by the terrorism in the U.S. "And these countries have little exposure to the weakening U.S. economy," he adds. ACLN plans to aim for new markets: South Africa, India, New Zealand, and certain nations in the Middle East. In addition, it will sell more new cars.

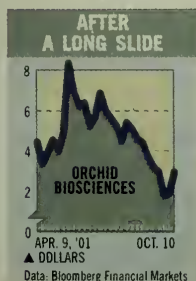
Axiom's Jordon is even more bullish on ACLN's earnings: He figures ACLN will exceed current estimates, and that for 2002, it will earn \$8.50 a share. On that basis, the stock, now at 37.90, is trading at an unusually low price-earnings ratio of 4.4. He expects the cash-rich company, which has no debt, to split its stock 2-for-1 this year.



ORCHID: A SOLDIER IN THE BIOTECH WAR?

Not only are investors flocking back to biotech, but new spice has been added: their potential role in fighting bio-terrorism. Shares of biotech companies that make products

to detect bio-weapons have soared: On Oct. 9, Cepheid jumped 86% in just one day, and Luminex climbed 18%. Dr. Anna Kazanchyan-Markarian of First Union Securities confirms that interest in such technologies has increased. One biotech whose stock has yet to capture much attention is Orchid BioSciences (ORCH), which has a proprietary detection technology known as single nucleotide polymorphism (SNP). SNP helps identify and



characterize genetic variations that are vital to drug discovery. Orchid's stock rose 1.25, to 3.55, on Oct. 9. It has since fallen to 3. The company has a pact with Luminex that allows Orchid's SNP gene assays to run on the Luminex LabMAP platform, which performs up to 100 assays simultaneously on a single lab specimen. Luminex technology, used mainly for drug research, could also be used to detect organisms that could be used by terrorists. Orchid, which has joined forces with AstraZeneca and Eli Lilly on SNP genotyping, may soon sign a European marketing pact with a large drugmaker.

Kazanchyan-Markarian, who rates Orchid a strong buy—and thinks the price will rise to 9 in 12 months—isn't recommending the stock as a bio-terrorism play. "Orchid is well on its way to becoming a fully integrated genetics-based diagnostics company, with a large, growing base of recurring revenues," she says. Kazanchyan-Markarian expects 2002 revenues to nearly double, to \$50 million, helped by its recent acquisition of Lifecodes, a leading provider of identity and forensic testing products. She sees Orchid making money in early 2004.

LOOKING FIERCE AT GRIFFON

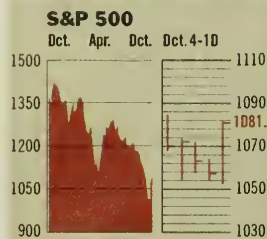
Recently, shares of Griffon (GFF) sprang up sharply, completing a V-shaped valley—after plunging from 11.20 on Sept. 10 to 9.92 on Sept. 17, the day trading resumed after the attacks. Two weeks later, the stock rallied to 12.20. Griffon makes building products and specialty plastic films. But what made its stock rebound so promptly was its third and smallest unit, which makes communications and radar systems for key defense programs, including the SH60R multisystem helicopter, and the Airborne Warning & Control system—and for the U.S. Air Force C-17 cargo planes that were used to drop foodstuffs to Afghanistan refugees. One money manager who has been buying shares says that, based on comparison with its industry peers, Griffon's defense operation alone is worth the current price of the stock, now at 11.05. He says the two other businesses are worth just as much, so he values Griffon at 20 a share. Analyst Laurence Baker of Legg Mason Wood Walker, who rates the stock a buy, expects Gifford to earn 82¢ a share in 2001 and 1.05 in 2002, vs. 2000's 75¢.



BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:10 p.m. EST on CNNfn's *The Money Gang*.

Stocks



COMMENTARY

The major U.S. stock indices ended in positive territory for the week, but the real star was the Nasdaq Composite, which rose four out of the five trading days and on Oct. 10 climbed almost 3%. Leading the charge that day for the tech-heavy index were Qualcomm, Intel, and Microsoft, which rose 9.9%, 6.5%, and 1.7% respectively on big volume.

Data: Bloomberg Financial Markets
Bridge Information Systems, Inc.

U.S. MARKETS

	Oct. 10	Week	Year to date	Last 12 months
S&P 500	1081.0	0.8	-18.1	-22.1
Dow Jones Industrials	9240.9	1.3	-14.3	-12.2
Nasdaq Composite	1626.3	2.9	-34.2	-49.8
S&P MidCap 400	449.6	1.6	-13.0	-10.6
S&P SmallCap 600	200.9	1.8	-8.5	-1.3
Wilshire 5000	9937.7	1.0	-18.4	-23.0

SECTORS

	Oct. 10	Week	Year to date	Last 12 months
BusinessWeek 50*	729.4	1.6	-24.8	-33.9
BusinessWeek Info Tech 100**	365.9	3.6	-35.3	-53.5
S&P/BARRA Growth	551.4	1.3	-19.8	-30.3
S&P/BARRA Value	529.6	0.3	-16.7	-13.6
S&P Energy	851.6	7.6	-8.6	-11.5
S&P Financials	135.6	-4.5	-17.7	-9.5
S&P REIT	90.3	2.1	2.7	8.4
S&P Transportation	598.9	1.9	-14.2	-1.1
S&P Utilities	265.7	0.7	-24.2	-19.2
GSTI Internet	82.1	5.0	-54.8	-77.4
PSE Technology	567.2	4.3	-30.4	-39.9

*Mar. 19, 1999 = 1000 **Feb. 7, 2000 = 1000

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Defense Electronics	36.0	Engineering & Constr. 89.1
Insurance Brokers	18.0	Tobacco 63.5
Genl. Merchandise Chains	12.8	Pollution Control 46.4
Long-Dist. Telecomms.	7.2	Toys 46.3
Multiline Insurers	6.9	Hardware & Tools 34.2

GLOBAL MARKETS

	Oct. 10	Week	Year to date
S&P Euro Plus (U.S. Dollar)	1007.3	5.3	-2
London (FT-SE 100)	5153.1	5.6	-1
Paris (CAC 40)	4319.4	7.3	-2
Frankfurt (DAX)	4613.2	4.0	-2
Tokyo (NIKKEI 225)	9964.9	-1.7	-2
Hong Kong (Hang Seng)	10,298.2	4.1	-3
Toronto (TSE 300)	6952.3	1.7	-2
Mexico City (IPC)	5684.9	5.1	

FUNDAMENTALS

	Oct. 9	Wk. ago
S&P 500 Dividend Yield	1.47%	1.47%
S&P 500 P/E Ratio (Trailing 12 mos.)	34.9	34.6
S&P 500 P/E Ratio (Next 12 mos.)*	19.7	19.5
First Call Earnings Surprise*	0.09%	-0.75%

*First Call Corp.

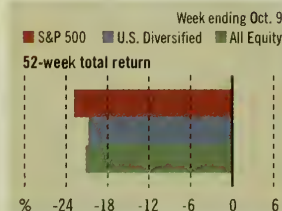
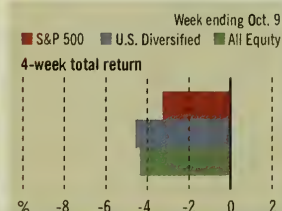
TECHNICAL INDICATORS

	Oct. 9	Wk. ago
S&P 500 200-day average	1219.8	1227.0
Stocks above 200-day average	35.0%	35.0%
Options: Put/call ratio	0.73	0.69
Insiders: Vickers Sell/buy ratio	2.59	2.90

WORST-PERFORMING GROUPS

	Last month %
Conglomerates	-26.8
Photography/Imaging	-21.8
Hotels & Motels	-21.6
Metals	-19.0
Airlines	-17.0

Mutual Funds



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-week total return	%	52-week total return	%
Leaders		Leaders	
Precious Metals	2.6	Precious Metals	24.0
International Hybrid	-1.5	Real Estate	10.3
Japan	-1.7	Small-cap Value	6.4
Domestic Hybrid	-1.9	Mid-cap Value	4.7
Laggards		Laggards	
Latin America	-11.2	Technology	-59.4
Diversified Emerging Mkts.	-9.8	Communications	-54.3
Technology	-8.9	Japan	-42.3
Pacific/Asia ex-Japan	-7.1	Mid-cap Growth	-38.4

EQUITY FUNDS

4-week total return	%	52-week total return	%
Leaders		Leaders	
ProFunds UltraShort DTC	13.0	Potomac Internet Short	188.2
Rydex Dynamic Vent. 100	12.9	Rydex Dynamic Vent. 100	136.1
Prudent Bear	12.8	ProFunds UltraShort DTC	126.3
Corbin Small Cap Value	11.6	Rydex Arkos Investor	90.6
Laggards		Laggards	
Apex Mid Cap Growth	-37.7	ProFunds UltraDTC Inv.	-90.3
American Heritage	-36.4	Berkshire Focus	-87.2
Frontier Equity	-22.9	Berkshire Technology	-87.1
Ameristock Focused Value	-20.7	Van Wagoner Post Venture	-84.0

Interest Rates

	Oct. 10	Week ago
KEY RATES		
MONEY MARKET FUNDS	2.84%	2.97%
90-DAY TREASURY BILLS	2.21	2.22
2-YEAR TREASURY NOTES	2.76	2.75
10-YEAR TREASURY NOTES	4.60	4.48
30-YEAR TREASURY BONDS	5.36	5.30
30-YEAR FIXED MORTGAGE†	6.55	6.51

†BancQuote, Inc.

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Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 31% federal tax rate.

	10-yr. bond
GENERAL OBLIGATIONS	4.00%
TAXABLE EQUIVALENT	5.80
INSURED REVENUE BONDS	4.22
TAXABLE EQUIVALENT	6.12

THE WEEK AHEAD

BUSINESS INVENTORIES Monday, Oct. 15, 8:30 a.m. EDT ► Inventories in August likely fell by 0.3%, after sliding 0.4% in July. That's based on the median forecast of economists surveyed by Standard & Poor's MMS, a unit of The McGraw-Hill Companies. Despite major efforts to trim down inventories, the deteriorating economy will likely require further reductions.

INDUSTRIAL PRODUCTION Tuesday, Oct. 16, 9:15 a.m. EDT ► Factory output probably declined 0.7% in September, while ca-

pacity utilization probably declined for the 13th straight month, to 75.6%. In August, output dropped 0.8%, with a utilization rate of 76.2%.

NEW RESIDENTIAL CONSTRUCTION Wednesday, Oct. 17, 8:30 a.m. EDT ► Housing starts in September are forecast to fall to an annual rate of 1.5 million, after dropping to 1.53 million in August.

CONSUMER PRICE INDEX Friday, Oct. 19, 8:30 a.m. EDT ► Consumer prices for

goods and services probably rose in September, after posting a 0.1% in August. Core prices, excluding more volatile food and energy components, are projected to rise by a 0.2%, after rising 0.2% in August.

INTERNATIONAL TRADE Friday, Oct. 19, 8:30 a.m. EDT ► The trade deficit probably narrowed slightly in August, to \$28 billion, from \$28.8 billion in July. Again, imports are projected to drop at a faster clip than exports.

BusinessWeek Fifty

Apr.

Oct.

Daily: Oct. 4-10

760

740

729.4

720

700

680

Weekly

se 1.6% for the week. It would have fared better but for weakness among such financials as U.S. (Boston Financial, and Washington Mutual, down 21.3%, 10.1%, and 8.1% respectively. Strong included ADC Telecommunications, up 25.7%, and Tellabs, 24.0%, in technology, and Anadarko Petroleum, up 9.2%, in energy.

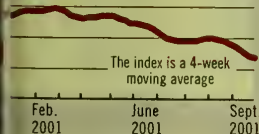
COMPANY PERFORMANCE

Company	% change		Rank	Company	% change	
	Week	Since 3/1/01			Week	Since 3/1/01
International	0.3	-14.2	26	Verizon Communications	-1.4	11.7
Petroleum	14.6	-13.4	27	Citigroup	1.9	-8.9
	-1.2	-40.3	28	Sun Microsystems	1.0	-54.7
	6.4	-9.4	29	Merck	1.2	-14.1
Materials	6.8	-28.5	30	El Paso	13.6	-25.7
Financial	-5.9	-60.0	31	Altera	16.7	-17.5
Petroleum	9.2	9.9	32	Marsh & McLennan	-1.4	-2.3
	13.5	-18.2	33	Household International	0.0	-0.3
ee	8.7	-13.9	34	ChevronTexaco	9.4	7.6
	4.6	-33.1	35	SBC Communications	1.6	3.1
Brothers Holdings	-0.2	-12.4	36	Mercury Interactive	5.1	-54.2
	2.9	-71.4	37	AOL Time Warner	-5.7	-26.5
	5.3	-74.8	38	Washington Mutual	-8.1	5.4
Laboratories	2.6	14.3	39	General Dynamics	0.2	34.1
Financial	-10.1	-20.0	40	Comcast	-2.2	-15.8
Technology	11.7	-40.9	41	Morgan Stanley Dean Witter	1.4	-20.4
	9.8	-29.3	42	Tellabs	24.0	-69.9
Hess	6.9	-7.0	43	Exxon Mobil	6.1	3.9
rgy	-1.9	-6.1	44	Scientific-Atlanta	-3.0	-60.8
Communications	25.7	-60.7	45	U.S. Bancorp	-21.3	-23.2
Financial	-1.1	-14.0	46	Paychex	7.6	-15.9
Petroleum	7.2	7.3	47	Merrill Lynch	2.9	-28.9
Services	6.7	-4.3	48	Bed Bath & Beyond	-3.9	8.3
Resources	15.1	-22.1	49	Texas Instruments	13.0	-11.9
Health	1.1	11.3	50	Teradyne	9.6	-26.3

Production Index

Change from last week: -0.4%
Change from last year: -8.1%

AL OUTPUT Sept. 29=163.3 1992=100



index was lower once again in the latest calculation of the four-week moving average rose to 163.0, from 161.7. On a seasonal basis, auto and truck production, electric power, crude-oil refining, and other were also higher for the week. Only for the fourth straight week, and lumber rose through September, the index slipped to 7.5 in August.

ch of the index components is at www.businessweek.com. Copyright 2001 by The McGraw-Hill

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GLOBALIZATION'S NEXT FRONTIER

It's difficult to know precisely what effect the launch of U.S. bombers and cruise missiles has had on the rugged, desolate Afghan landscape. But the effect outside Afghanistan's borders is clearer: Many nations have expressed support for the U.S. attack. But among some people in the Islamic world, the bombing has aroused opposition, intensifying anti-American sentiments and sparking violent demonstrations (page 34).

What is happening is a clash not between Islam and Christianity, or between the East and the West. Instead, it is a clash between Islamic fundamentalism and the modern world—a violent encounter between the adherents of two bitterly opposed world views who are now locked in a kind of global combat not seen since the fall of communism and the end of the cold war.

This new conflict threatens to upend a decades-long global progression toward tighter economic, political, and social integration—the process known as globalization. Fueled by trade, globalization has advanced the ambitions, and boosted the bottom line, of some of the world's largest corporations, many of them based in the U.S., Europe, and Japan. It has given developing countries an opportunity to join the growing global economy and share in the wealth, a necessary—if not sufficient—step toward easing poverty, tyranny, and local conflicts around the world. In many developing countries, it is working: Life expectancies and per-capita income are rising. Local economies are growing. And in some cases, this new membership in the global economy has encouraged social and political liberalization.

But the road to globalization has not been smooth. Critics

have charged that it has excluded many of the world's poor and that the move toward prosperity has sometimes come at the expense of human rights. Much of the criticism in the West calls for the reform of globalization, not its undoing. For many Islamic fundamentalists, globalization represents an intolerable secularization of society.

Reports from *BusinessWeek* correspondents around the world suggest that the terrorist attacks of September 11 will likely slow globalization. The perception of risk is added to the costs of doing business in this transformed world. Globalization depends on open borders and ready access to transportation and communications. All of those things are imperiled in a world wary of terrorism. Restrictions on travel, on crossing borders, on communication, on the shipment of goods, and on immigration are already in place, and will be toughened in the coming weeks and months. Those moves will slow globalization and retard the growth of the global economy. That, in turn, could further damage an already troubled U.S. economy.

The U.S. must search for opportunities to reach across the divide separating Islamic fundamentalists from the West. We must find the moderates in Arab countries, the people who are able to find a way to honor their religion and at the same time participate in the global economy. Security is an immediate concern, as it should be. But global equity, progress, and economic growth must still be our long-term goals. The U.S. must now do everything it can to see that the long trend toward a more integrated and more prosperous world continues.

NEW YORK CAN REINVENT ITSELF AGAIN

Will New York ever be the same?

The collapse of the World Trade Center on September 11 dealt a massive economic blow to a city already experiencing an economic downturn. More than 100,000 New Yorkers are likely to be thrown out of work by the attacks, and the city will lose an estimated \$90 billion in output during the next three years. And because New York plays such a vital role in the global economy, its troubles will have repercussions around the world (page 96).

New York has pulled itself back from the brink of catastrophe before. In the 1970s, the city's high crime rate and budget crises verging on bankruptcy sent many residents fleeing for the suburbs. But the city harnessed its strengths, fought its way back, and moved into an era of unprecedented prosperity, safer and cleaner streets, smaller welfare rolls, and a flourishing of culture and commerce.

Now the city faces another challenge. It will get help from the federal government, as it should: We are so quick to say that New York is a global city that we sometimes forget it is a regional city, too—a vital piece of the U.S. economy.

But the federal government's contribution will fall far short of what the city will need to rebuild, to replace lost tax revenues, and to keep the trains running, the schools open, and the government functioning. So it must rely mostly on itself.

New York's next mayor, who will take office in January, must do whatever is necessary to maintain the city's global financial leadership. He should move quickly to rebuild the financial district and put the highest priority on rebuilding its badly damaged transportation system. He should enlist the help of the city's business community, which has a responsibility to contribute to the rebuilding. And while it will be difficult to balance the budget, he must not neglect the schools, parks, or crime-prevention efforts.

New York is a city of neighborhoods, of people working together, shoulder to shoulder. The concentration of people and interests is part of what gives the city its energy and resilience. No, the city will never be quite the same again. But New York has reinvented itself throughout its 400-year history. The task ahead is daunting, but not insurmountable. New York can reinvent itself once again.



not here.

A man in a dark suit and glasses is seated in a black office chair, facing right towards a computer workstation. He is in a server room, with rows of server racks visible in the background. The room has a white tiled floor and a drop ceiling with fluorescent lights. The word "here." is overlaid in large white text across the center of the image.

here.



BusinessWeek

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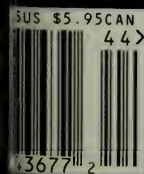
**AMERICAN
EXPRESS**

Tough Times For a New CEO

BY JOHN A. BYRNE
AND HEATHER TIMMONS

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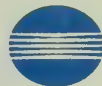
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yellow
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MINOLTA

The essentials of Imaging

Like a superstitious painter afraid of offending anything on his palette, Tim Burton politely refrains from picking a favorite color. But ask him about his least favorite and you'll get one impassioned word: yellow.

Yellow is an obvious color, says Burton. It simply does not fit in the stories he tells on film, stories of mysterious possibility where the line between fantasy and reality is deliberately blurred.

Yellow has no place in a world where the scary house down the block is clearly inhabited by an aging mad scientist; a nine-volt battery and some aluminum foil can bring your dead dog back to life; and aliens have not only visited us, but will be back soon with reinforcements.

With yellow, what you see is what you get, a quality that nothing in Burton-land shares.

But surely there must be another reason, a psychological torment that would create such a powerful emotional response to a mere color.

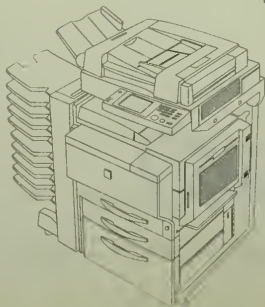
The truth is that Burton hides a deep, dark personal secret about yellow — one that he has never confessed until now.

It turns out that, like many teenagers in the 1970s, Mr. Burton made a somewhat dubious fashion choice when he picked out a tuxedo for the prom. Think polyester. Think polyester ruffles. Think bright yellow polyester ruffles.

"It was horrible," Burton says. "I looked like a bee, and I acted like Carrie."

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A full-page photograph of an elderly woman with short, wavy grey hair, wearing dark sunglasses and a vibrant green sleeveless dress with a chevron pattern. She is also wearing a lei made of purple and yellow flowers. She stands on a concrete path with a metal grate, with the ocean and a clear sky in the background.

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COVER STORY

A YEAR OF TRIAL

Ken Chenault's new job at the helm of American Express has proved more challenging than he could ever have imagined

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BusinessWeek

OCTOBER 29, 2001

Cover Story

64 TOUGH TIMES FOR A NEW CEO

What looked so good just a year ago has turned sour. Ken Chenault had finally gotten his dream job, taking over the helm at American Express, a respected, successful enterprise with record earnings. Then came surprise write-offs, skittish consumers no longer slapping down plastic, a stock plunge, and the close-to-home shock and tragedy of September 11. One of the few African Americans to achieve the corner suite at a major corporation, Chenault has been tested before and prevailed. Will his decisiveness, experience, and heart succeed now?

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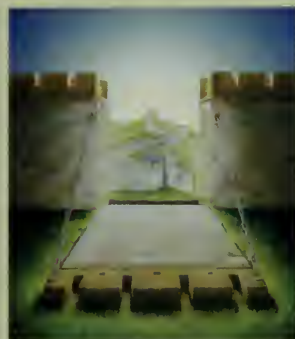
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Bureaucratic Babel

Commentary: Hard to believe, but the State Dept., the FBI, and the INS have no access to one another's files. In the interest of security, that must change



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Up Front

EDITED BY SHERIDAN PRASSO

DEFENSE DEALS

BOEING GETS BEAT

BOEING IS BRACING FOR yet another big blow: Pentagon sources tell *BusinessWeek* that Lockheed Martin is set to beat out Boeing for the largest defense contract in U.S. history: a \$225 billion order for next-generation fighter jets, replacing the F-16. With an additional \$175 billion in future sales to allies overseas for the next 25 years, the contract is worth at least \$400 billion. Contract engineers confirm they've been asked to submit applications to Lockheed, but not to Boeing, to work on the jet. The Pentagon plans to announce the winner Oct. 26, after five years of testing.

Compare the two designs for the Joint Strike Fighter, and you'll see the obvious: Boeing's looks like "a flying frog with its mouth wide open," says a Pentagon source. Air Force officers have tastelessly dubbed it "Monica." Lockheed's design to replace the F-16 is simply better on technical and aesthetic grounds, they say, citing its better vertical-lift capability. "The Lockheed design wins hands down," says a senior Air Force general. The Air Force will buy 60% of the initial 3,000 planes; the rest go to the Navy, Marines, and to Britain.

Boeing officials, of course, say looks aren't part of the design and argue in favor of the jet's performance and their ability to meet the Pentagon's cost target of \$30 million per plane. And they're not counting themselves out. "We design our planes to go to war, not to the senior prom," scoffs a Boeing spokesman. Pentagon officials aren't talking publicly. Lockheed officials say they're cautiously optimistic.

Boeing already cut 30,000 jobs and delayed aircraft deliveries after September 11. It will now likely exit the fighter-jet business and lose engineering talent to Lockheed. Winning the contract would have restored 6,000 jobs in Seattle and St. Louis. Lockheed's Forth Worth, Tex., factory which now builds F-16s, expects to now need 9,000 new workers. Boeing still makes F-18 fighters and C-17 cargo jets. *Stanley Holmes*

DUEL: Boeing (top), Lockheed jets



WARTIME SHORTAGES

EVERY SNIFFER DOG HAS ITS DAY

PACKAGE SCARES ARE EVERY-where. But just try getting a sniffing dog these days. With malls, offices, and entertainment venues boosting security, the dogs are in such demand that the nation's few dozen private services are booked solid and running out of dogs to train.

LAB AT WORK:
The nose knows



The dogs search mainly for explosives but can also detect weapons and contraband. They used to work eight-hour days, one or two days a week; now they're putting in 16-hours, seven days a week, making \$2,500 a day. "I used to write \$300,000 of business a month. Now we're booking \$1 million a week," says Russ Ebersole, owner of DDADE sniffer dogs. And, no, they can't sniff out anthrax.

Kimberly Weisul

TALK SHOW "Iron your letters."

—Leading germ-warfare scientist Ken Alibek, briefing Congress. He says putting a moistened fabric over envelopes and then ironing them will kill anthrax spores.

EAT, DRINK, BE MERRY

WHAT-THE-HELL CONSUMPTION

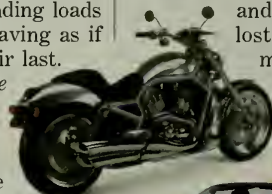
CONSUMER CONFIDENCE IS low, unemployment is rising. And we're at war. These days, it seems the news is all bad, all the time. But rather than retreat, some people—particularly those in the upper economic echelons—are boozing it up, spending loads of money, and behaving as if each day were their last.

Call it the *carpe diem* effect. It's different from consumer patriotism, where the middle class is urged to spend at now-discounted prices. *Carpe diem* consumers are buying big-ticket luxury items.

"People at the very top don't face a budget crunch," says Robert Frank, economics professor at Cornell University. Whether this desire to "seize the day" will help the economy is difficult to measure, but here are some examples from around the nation:

■ Ken Gorin, co-owner of luxury-car dealership The Collection in Coral Gables, Fla., reports "a high-end contagious energy" among cus-

tomers buying \$75,000-and-Porsche 911 Carreras. "Sir September 11, we've seen people who were sitting the fence about buying a car now buying," he says. "People are saying, 'It's okay, go out and enjoy myself.'" ■ Dan Kendt, who owns Cactus Bar & Grill in Chicago's financial district, finds patrons living it up. "There's a sense of 'It's only money and maybe I've lost a lot, but money is



TOYS: Harley V-rod, 911 Carrera

everything,' particularly relating to the attacks. I mean, would you rather have a stock portfolio or a fast car?" ■ Chuck Matthews, who sells \$18,000 Harleys in Lancaster, Calif., reports doing big business: "People are buying them, because you never know what tomorrow brings."

Right now, it's almost a relief to know the hedonists among us are doing what they do best. *Julia Cosgrove*

THE LIST KILLER KITSCH

On the Internet, you can play the game "Get Osama." There are also a variety of anti-bin Laden products hitting the market.

Some examples:

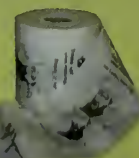
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Up Front



BERLUSCONI: A new law undercuts cases against him

tional judicial cooperation," says Heinrich Koller, director of the Federal Office of Justice in Bern, Switzerland.

The new law also benefits Prime Minister Silvio Berlusconi

EUROPEAN DISUNION

LOOPHOLES FOR TERROR MONEY?

WHILE ALL EYES FOCUS ON antiterrorism efforts, Italy is quietly becoming a weak link in the coalition. The Italian government passed a law on Oct. 3 that makes it more difficult for magistrates to investigate suspicious cross-border financial flows.

The change may be a boon to terrorists, mafiosi, and plain old white-collar criminals. With other countries, such as Germany and France, tightening controls, followers of Osama bin Laden may find Italian banks a less risky bet for funding terrorist activities. Even if they're caught, Italy's new law makes it harder to obtain evidence, such as records from a Swiss bank account. "We are worried that... the law could slow interna-

con by derailing pending lawsuits against him for tax fraud, bribery, and false accounting. Another bill passed in September will partly decriminalize false accounting, shorten the statute of limitations on such cases, and reduce penalties for the guilty. Even Berlusconi backers are cringing with embarrassment at his rush to undercut suits against him. Still, at a meeting with President Bush on Oct. 15, Berlusconi pledged to help fight terrorism.

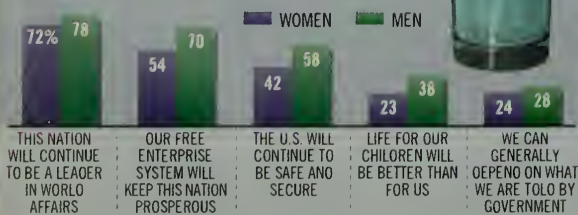
As Europe knits itself closer together politically and economically and races to boost cross-border cooperation, such measures are at odds with European conventions and U.N. counter-terrorism directives now in the works. With attention diverted, Berlusconi has won his own private battle with Italy's justice system—at a cost to international security. *Gail Edmondson*

THE BIG PICTURE

MALE OPTIMISM

When asked about their confidence in the future, men tend to respond more positively than women.

PERCENTAGE THAT ARE "VERY CONFIDENT" * THAT:

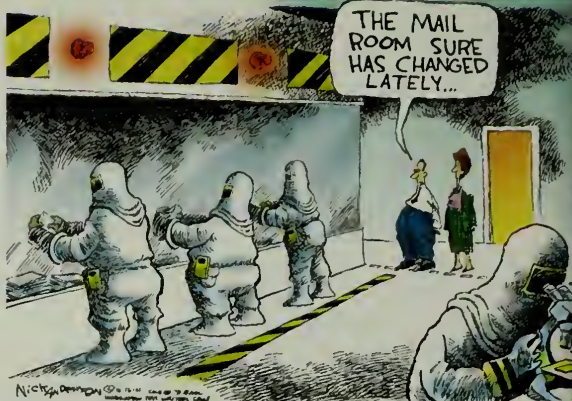


*WHEN ASKED IF THEY WERE "VERY CONFIDENT," "CONFIDENT," OR "NOT CONFIDENT"

TELEPHONE SURVEY OF 1,008 ADULTS, SEPT. 17, 2001

Data: Roper/ASW

DRAWN & QUARTERED



SLUGFESTS

RALPH LAUREN ISN'T HORSEING AROUND

DON'T COUNT ON seeing much merchandise from the U.S. Polo Assn. in stores this season. The sport's governing body says retailers aren't placing orders for its fall, holiday, and spring lines because of pressure from Polo Ralph Lauren. The stores include T.J. Maxx, Bolton's, and Strawberry. "We were selling very well," says Robert Mintz, the Polo Assn.'s master licensee. "Now, we're not even going to be able to put product on the floor."

Lauren and the USPA have been duking it out in court, with Lauren charging that USPA's double-horseman logo (circa 1996) is too similar to Polo Ralph Lauren's 30-year-old horseman. It's the latest fight in a battle that's been going on since 1984. But now, Lauren seems to have run out of patience with the courts. Rather than waiting for a legal opinion this fall, it mailed a 2-inch-thick binder to retailers in May, warning that many USPA designs violate Lauren's trademarks. "We believe that that kind of activity is harmful to consumers and violates our rights," says Lauren lawyer Les Fagen. In July, a USPA countersuit said Lauren had approved the double horseman in previous settlement talks

LOGOS: Lauren's (left) and the Polo Assn.'s

and now has "maliciously acted to destroy" USPA's retailing.

Malicious or not, the letters are working—Mintz says the six retailers he knows received them, five put their orders on hold. *Kimberly We*

STAR-SPANGLED WALLETS

Half of Americans surveyed online said they planned to buy financial products specifically to help the U.S. economy. Here's what they chose.*

STOCKS	53%
MUTUAL FUNDS	50%
GOVERNMENT BONDS	34%

*RESPONDENTS WERE ALLOWED TO SELECT MORE THAN ONE ANSWER

SURVEY OF 1,004 AMERICANS, SEPT. 23-24

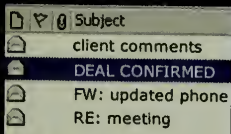
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ECONOMIC UNCERTAINTY DOES THE REAL DAMAGE

Lessons from Britain and Israel suggest that random and persistent terrorism is frightening but can be managed—and, if sporadic, will have a limited psychological effect on society (“Understanding a new world of uncertainty and risk,” Cover Story, Oct. 8). If terrorism does become chronic, democratic society will go to war against it in full force.



The true perniciousness of uncertainty is economic in origin and effect. One has only to observe the anxious Japanese consumer to confirm this. Without any real terrorist threat, Japan has been stuck in a quagmire of uncertainty for more than a decade. As opposed to the acute fear of terrorism, economic crises can and do linger on, and this is the real threat that we face in the world today. Unfortunately, the culprit is not so easily identified. Our current financial crisis, though aggravated by terrorism, has not been caused by it, and terrorism will not determine its outcome.

Michael Harrington
 Santa Monica, Calif.

The public outcry against military actions to eradicate terrorism is flawed and irrational. No sane person objects to the police pursuing a serial killer. The public and the media would criticize the police if no prompt action were taken. Terrorists and serial killers have many things in common—including their viciousness.

It is not only our democratic duty

but also our moral responsibility to support our democratic governments in taking tough action against the terrorists wherever they are hiding, and the governments that harbor them. It is every civilized person's responsibility to protect children and society by supporting military action against terrorism.

There is no other alternative.

Peter
 Budapest

BRING BACK 'STANDBY' EXTENDED UNEMPLOYMENT BENEFITS

Rather than enact the sweeping emergency-benefit extension now before it, Congress should resurrect “standby” extended benefits funded by state payroll taxes and half by federal unemployment payroll tax (“Washington tries to spell relief,” Special Report, Oct. 8). Every state ready to pay standby extended benefits at a moment's notice. Moreover, benefits would be paid only in states that are suffering from high unemployment and exhaustion of first-tier benefits, not states that manage to escape (or forestall) high unemployment. Finally, the benefits would be paid from existing trust funds that have been aside expressly for this purpose.

Stephen A. Woodbury
 Kalamazoo, Mich.

HOW TO OVERHAUL THE TRAINS AND THE PLANES

The proposed federal bailout of the airline industry should be contingent on the major carriers reducing their share of flights at any one airport to below 50% (“A bailout—with strings attached,” Special Report, Oct. 8). This would mean dominant carriers would have to sell off gates, facilities, and other

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Readers Report

sets to competing carriers, so that one company controls the majority of an airport's traffic. The U.S. General Accounting Office, which has expressed great concern over these airline hub-and-spoke systems, has concluded that greater competition would result in much lower fares. Airlines that don't want or need a federal bailout would not be affected.

Kenneth H. Thompson
Philadelphia

It would be to this nation's advantage to expand Amtrak service to make it profitable ("What kind of role?" Special Report, Oct. 1). We should not rely on one system of mass transit. Trains can help relieve airport traffic and are probably easier to make secure.

David Allen Hinkley
Kingston, N.Y.

PUTTING SECURITY ISSUES UNDER THE MICROSCOPE

There is no intrusion upon a person's privacy from government records of fingerprints or similar biometric data from the requirement of a national identity card. ("Security vs. civil liberties" Special Report, Oct. 1).

By contrast, dossiers of nonbiometric data do pose a threat to privacy and civil liberties—such facts as religious beliefs, political beliefs, organizational memberships, familial relationships, sources of income, expenditure patterns, etc.—such dossiers must be maintained on a very limited portion of the population [we need] the most stringent safeguards to assure confidentiality and that the information is never used in an improper or illegal manner.

Benjamin D. Sherman
Saddle Brook, N.J.

BETTER BLOOD THROUGH SCIENCE

"New, improved blood" plays upon readers' fears by invoking the specter of mad cow disease (Science & Technology, Oct. 8). Biopure Corp. manufactures oxygen-carrying pharmaceuticals using a patented process that incorporates rigorous material controls to prevent the introduction of pathogens. Biopure also employs patented purification techniques that have been validated to remove and inactivate potential infectious agents present, including bacteria, viruses, and the agents that cause mad cow disease and its human equivalent. Biopure purifies its raw material, bovine hemoglobin, from managed herds of U.S. beef cattle with documentation assuring the origin.

Books

GOOD TO GREAT

Why Some Companies Make the Leap... and Others Don't

By Jim Collins

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BREAKING FREE OF THE CORPORATE PACK

Author Jim Collins had every reason to be smug. The 1994 blockbuster *Built to Last*, which he co-wrote with Jerry I. Porras, had gone through 40 printings and had been translated into 13 languages. Now, two years later, Collins was preparing a new introduction for the paperback edition, which was all but guaranteed to go right back on best-seller lists. Then one night, a former colleague from McKinsey & Co. leaned over the dinner table and, figuratively, jabbed him in the eye. His table-mate had one word for the book: "useless."

Merck & Co., General Electric Co., and the other 16 visionary enterprises profiled in *Built to Last* had always been great, the McKinsey exec complained. A better exercise, he argued, would be digging into a more practical question: How can a run-of-the-mill business transform itself into one as extraordinary as those in *Built to Last*'s pantheon?

After five years of research, Collins has answered that challenge with the publication of a solo venture, *Good to Great*, and it's just as astute and accessible as his earlier work. The follow-up spotlights 11 big U.S. corporations that went from average to A+ performers on Wall Street, or from good to great. The book, which has the same quick-read tone and format of *Built to Last*, right down to the Socratic Q&A at the end, also crunches decades of data and uses interviews and archives to divine what separates these over-achievers from a control group of peers that didn't make the leap. "Five years after that fateful dinner, we can now say, without question, that good to great does happen," Collins writes.

The 11 are generally not the mar-

quee names routinely praised on the covers of business magazines. Indeed, the chief executives of these newly great companies are almost anonymous. And some of their successors did lose their way, allowing their firms to slide back toward mediocrity. Yet for a long stretch, these companies managed to outshine everyone else: The share price of each exemplar in *Good to Great* ad-

vanced three times as fast as the overall stock market during the 15 years from the company's breakthrough point. Not even GE under recently retired CEO Jack Welch was able to clear that bar. "The surprising list—a dowdier group would be hard to find—taught us a key lesson right up front," writes Collins. "It is possible to turn good into great in the most unlikely of situations."

Before we go further, here's the list: Abbott Laboratories, Circuit City Stores, Federal Home Loan Mortgage, Gillette, Kimberly-Clark, Kroger, Nucor, Philip Morris, Pitney Bowes, Walgreen, and Wells Fargo. The laggard in the group, tissue-products maker Kimberly-Clark Corp., saw its stock climb 3.42 times as far as the market in its 15-year post-breakthrough period, while consumer-electronics retailer Circuit City Stores Inc. rose 18.5 times as fast. Dowdy, perhaps. But with returns like that, who needs flashy?

So how did they go from good to great? Not, Collins found, by doing things that many in the business world advise, such as tapping a hard-charging celebrity commandant from the outside. Of the 11 CEOs who put their companies on the fast track, 10 had come up through the ranks. And three of them



lical history, feed (no mammal pro-), and young age of the cattle. In ad-on, Biopure intends to seek a product in the U.S. and Europe for use of product in general elective surgery, just orthopedic surgery.

Carl W. Rausch
Co-founder, Chairman, and CEO
Biopure Corp.
Cambridge, Mass.

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HOW 11 OUTFITS EXCELLED—WITH NO CELEB CEOs OR MEGADEALS

Books

were the ultimate insiders: members of the family dynasty that controlled the outfit. Nor did any of these corporate alchemists get there through layoffs, megadeals, high-tech pursuits, or far-flung diversification. Most could not even recall a "eureka" moment.

Yet these CEOs rose above their peers. Collins dubs them "Level 5" managers. By this definition, each was humble to a fault and hid from the limelight. At the same time, though, all of them went to extraordinary lengths to make their companies great. For Darwin E. Smith of Kimberly-Clark, that required jettisoning the core business when he sold its paper mills. For George Cain at Abbott, it meant firing his own relatives. These leaders' ambition was "first and foremost for the company," writes Collins. They were "concerned with its success, rather than their own riches and personal renown."

Next, even before they had settled on a business plan, these CEOs surrounded themselves with smart, hard-working people who were not afraid to face their shortcomings and hurdles—the "brutal facts," as Collins puts it—but who had faith they would ultimately win. After settling on a course, the com-

panies on the list never lost sight of what they did best, and they maintained tough standards for their people. New hires either fit right in—or were quickly ejected. Then, through perseverance and the careful use of technology, the enterprises lifted off. "The process resembles relentlessly pushing a giant heavy flywheel in one direction, turn upon turn, building momentum until a point of breakthrough, and beyond," Collins concludes.

Kroger, for instance, blew past its competitors in the early 1970s by realizing that the superstore would overtake the traditional grocery store. Then, market by market over the next 20 years, it went with the new format, as its closest rival, A&P, clung to its original stores until it was too late. "Sure, there was some skepticism at first," former Kroger CEO Lyel Everingham told Collins. "But once we looked at the facts, there was really no question about what we had to do. So we just did it."

As instructive as Collins' research is, his book isn't perfect. He uses just one gauge to measure a company's greatness: its share price over 15 years. He points out that he picked a long time frame to edit out one-hit wonders, but

as we've seen from the phenomenal surge and subsequent bust in the Internet and telecom sectors, stock price may not be the best way to judge a company's real and lasting nature. The market leaders are not always share price superstars or profit leaders.

Also, a few of the *Good to Great* companies no longer seem so great. Nucor Corp., for example, had a spectacular run from 1975 to 1990, when the steelmaker's share price rose 5.16 times as rapidly as the overall market. Over the next 10 years, however, Nucor trailed every major stock index, as it has gone through four CEOs. Gillette, too, has been on a steady decline since early 1998, and Wells Fargo was taken over that same year. So much for its legacy.

Still, it's clear that Collins has found a clutch of companies that did transform themselves from so-so to outstanding for at least a 15-year run. As he makes a reasoned argument for how this occurred. Management how-to books can be as faddish as pop music. But Collins again has written a book that seems built to last.

BY MICHAEL ARNDT

Arndt covers management issues from Chicago.



BOOK BRIEFS

THE AGENDA

What Every Business Must Do to Dominate the Decade

Michael Hammer

Warren Business • 269pp • \$27.50

WELL-WORN IDEAS

Michael Hammer is one of those celebrated big thinkers of the business world. *Reengineering the Corporation*, 1993 best-seller co-authored with James Champy, prompted managers to overhaul their business structures in suit of dramatic improvements. Some succeeded, but by the end of the decade, the term had also become synonymous with layoffs and plant closures. Meanwhile, Hammer seemed bogged down by his very success. Subsequent books, *Reengineering Revolution* and *Beyond Reengineering*, left some wondering if the Massachusetts Institute of Technology-trained consultant could ever move on to a new buzzword.

Well, he has and he hasn't. Hammer finally produced a book that doesn't have "reengineering" in its title. But in new work, *The Agenda*, reads more like a digest of others' well-worn ideas in a guidebook for the 21st century. Hammer insists that no one big idea

can turn a company around. Instead, he offers nine notions to fuel success in what he calls the customer economy. Most are based on the premise that the customer is king and deserves a hassle-free, value-added experience. Others stress the need for teamwork, discipline, measurement, and what General Electric Co. ex-chief John F. Welch has long called the boundaryless corporation. Hammer's most interesting idea—the need to bring order to the "chaotic" world of selling products—is also one of the few controversial ones, as it views improvisation and reliance on charismatic leaders as signs of dysfunction.

At its core, *The Agenda* is another book about how the days of selling to eager, captive customers are over. (No revelation there.) Instead, Hammer writes, "customers now have the upper hand and, to them, you are the necessary evil." Some might question this idea: If anything, technology is giving corporations the upper hand to slice and dice the customer base so that the top tier gets exquisite service and all others get less attention than ever. But even those who quibble with Hammer's analysis of customer power would agree that a customer focus is important.

What can readers glean from *The*

Agenda? If they have been keeping up with current business wisdom, the answer is: probably not much. Hammer offers up suggestions that are familiar, albeit hard to execute. First is the notion of becoming easy to do business with, through such things as anticipating what customers will want. Then there's the idea of adding value: "Think of yourself as a provider of solutions, rather than of products or services," Hammer writes. Of course, that was the mantra at Xerox Corp. before it lost its luster.

The discussion perks up when Hammer talks about the need to "create order where chaos reigns." Chaos is how he describes the free thinkers, entrepreneurial spirits, and other types who flout company rules. They need discipline and structure for the organization to succeed. At least Hammer has some passion for this subject, comparing such chaos to herding cats and to food fights.

All the same, one gets the sense that Hammer wrote *The Agenda* largely because he felt pressure to produce something new. He certainly can turn out a bright, breezy text. But chances are, his ideas are already on the agenda of smart managers.

BY DIANE BRADY



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BY STEPHEN H. WILDSTROM

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HOW TO SIDESTEP XP'S PUSHY PITCHES



Microsoft works hard to steer you to its owned or affiliated services, but escape is possible

Microsoft has been taking some well-deserved lumps for the way it uses its Windows XP operating system to promote the company's other products and services. It isn't the only software maker to pepper its products with tie-ins and other pitches, but Microsoft's inescapable presence on most computer screens makes its efforts to leverage a little bit more out of its customers especially offensive.

Fortunately, if you resist Microsoft's initial pleas, it's not hard to make them go away. Most will give up on their own fairly quickly, and others can be ignored. Strictly speaking, this column describes only what you will see if you upgrade a computer to XP. PC manufacturers will use customized setups, so you may see even more pitches as America Online Inc. vies with Microsoft's MSN to be your Internet service provider.

One of the most annoying things about XP is its nagging attempts from the setup process on to get you to sign up for Microsoft's Passport service. Passport will eventually allow a single login to a variety of Web services but currently works mostly with Microsoft-owned or -affiliated services, such as Hotmail, MSN, and Expedia's travel site. The only advantage I can see at the moment to integrating Passport into XP is notification of new Hotmail messages and easier access to your inbox. Contrary to some reports, you do not have to sign up for Passport to use XP. Ignore the request five times and it won't bother you again, though it leaves behind an icon in the lower right corner of the screen; click it, and you get another Passport ad.

Still, Passport is a lot less persistent than Netscape 6.1. It is virtually impossible to use the new browser from the AOL subsidiary without setting up accounts for Netscape Webmail and AOL Instant Messenger.

Microsoft also uses the quick-launch area of the redesigned Start menu to promote company products such as Windows Media Player and MSN Explorer, a browser that is tightly linked to

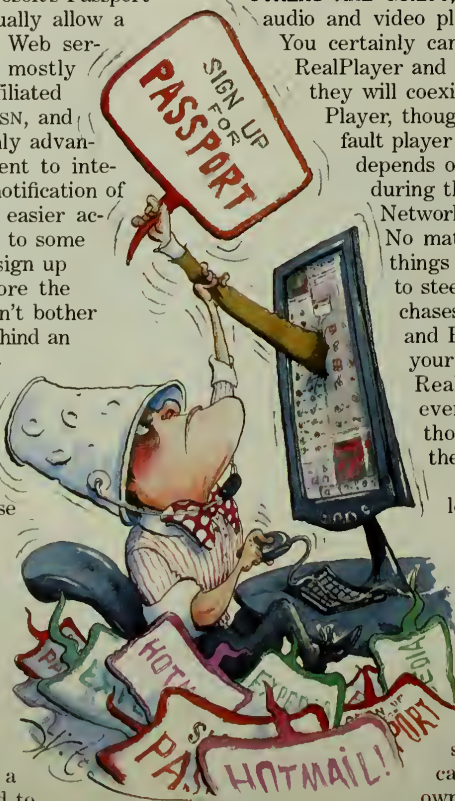
MSN services. As you use other programs, they gradually replace the initial offerings, though the system seems to have a chronic Microsoft bias. After extensive use, one of my XP computers continues to offer Microsoft Movie Maker on the list even though I have never used the program. I finally got rid of it by using an option that lets you start over with an empty program list. On the whole, XP does a reasonably good job of making your most frequently used programs the easiest to launch.

If you don't want Windows to suggest program choices to you at all, you can easily go back to the Windows 95-style start menu. Click on the Start button, select Properties from the menu, and click on Classic Start Menu. Nearly every feature of the Windows XP user interface can be customized, often to a considerable extent. Just click on a window or other design element you choose Properties, and explore.

Another source of irritation is the way Microsoft tries to steer your online music or photo business to either its own services or third parties that have, in effect, paid Microsoft to take space on your desktop. By default, when you plug a digital camera into an XP computer, it brings up a Scanner and Camera wizard that gives you an opportunity to send pictures to a Microsoft partner for printing. But when, for example, you install the software for a new Hewlett-Packard camera, it will bring up a photo-processing program instead.

OTHERS ARE GUILTY, TOO. The situation with audio and video players is more complex. You certainly can install RealNetworks' RealPlayer and RealJukebox on XP, and they will coexist with Windows Media Player, though which will be the default player for what types of media depends on the choices you make during the rather complex RealNetworks installation procedure. No matter how you do it, though, a few things will happen: XP will steer your online music purchases to WindowsMedia.com and RealNetworks will space your desktop with icons for RealNetworks products, even adding one for AOL, though you can just delete them.

Microsoft's efforts to leverage its desktop monopoly is especially egregious, but it is neither the only, nor the most obnoxious, player in this game. It is time for the whole software industry to grow up and show a little respect for consumers, who are quite capable of making their own intelligent choices.



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BY LAURA D'ANDREA TYSON

WHY BUSH'S STIMULUS PACKAGE WILL LEAVE THE U.S. WEAKER



REALISM:
If the tax cuts slated for the next 10 years aren't rolled back, the nation faces soaring deficits—or the gutting of Medicare and Social Security

Laura D'Andrea Tyson is dean of the Haas School of Business at the University of California at Berkeley.

In the wake of the tragic events of September 11 and the ongoing war on terrorism, the American economy finds itself in need of two kinds of insurance: insurance against a severe recession in the short run and insurance against escalating deficits and debt in the long run. A stimulus package consisting of temporary increases in government spending and temporary tax relief can provide the first kind of insurance. Fortunately, both its political and financial price tags are relatively small. A fiscal stimulus in the range of \$100 billion to \$120 billion is only about 1% of gross domestic product and can be easily covered by the surplus Social Security revenues available next year.

Moreover, at this moment of bipartisanship, the politics of spending more and taxing less is even more attractive than usual, so members of Congress should be able to reach agreement quickly. There's no guarantee, however, that they will fashion a sensible package that is limited to temporary measures to boost demand during the next six to nine months, when the risk of recession is greatest. In fact, the stimulus proposal circulated by the Bush Administration violates these conditions. Most of its components are tax cuts, many of them permanent, and they include accelerating the 1% reduction in income tax rates currently scheduled for 2004 and 2006 to 2002. This acceleration would add little to demand in 2002 but would significantly curtail government revenues in later years. If the 2004 rate reductions were accelerated, about two-thirds of the lost revenues would occur after 2002; if the 2006 reductions were accelerated, nearly four-fifths would occur after 2002. In either case, most of the tax relief would benefit the top one-quarter of all income tax filers, who are likely to save more and spend less from tax cuts than those who have lower incomes and tend to spend whatever extra income they have.

Surely there are more effective and more equitable ways to stimulate demand in the coming months. Temporary spending increases to strengthen homeland defense, a temporary cut in payroll taxes for low-income workers, and an extension of unemployment benefits are three obvious alternatives.

The second kind of insurance needed by the economy—insurance to restore the long-run health of the federal budget—requires a multi-year budget plan that covers the real costs of both the war on terrorism and the country's commitments to current and future retirees. Unfortunately, if the Bush Administration's stimulus

proposal is adopted, its permanent toll on government revenues will require even more painful trade-offs among the nation's priorities.

Even before the terrorist attacks, the huge cuts scheduled over the next decade had dealt a severe blow to the nation's long-term fiscal outlook. According to both the Office of Management & Budget and the Congressional Budget Office, during the next decade, the federal surplus will be limited to funds earmarked for Social Security and Medicare. The Bush Administration's tax cuts have wiped out the remaining budget surplus. Even this sobering conclusion rests on accounting gimmicks, optimistic economic forecasts, and the unrealistic assumption that federal spending on all nondefense programs outside of Social Security will continue to decline in real per capita terms, hitting an all-time low as a percentage of the economy by 2010. Merely holding spending on these programs—including everything from public health to infrastructure to education—constant in per capita terms would cost an additional \$250 billion of the next decade. And that's without any new spending on anti-terrorism measures.

LONG-TERM HEALTH. Unlike wishful thinking, realistic budget projections lead to an inescapable conclusion: Unless the tax breaks slated for the next 10 years are rolled back, ensuring the budget's long-term health will require either harmful, economically unwise cuts in other parts of the government budget or a return to escalating budget deficits as soon as next year. If we choose budget cuts over deficits, the Social Security and Medicare surpluses projected over the next decade will have to bear the brunt of the budgetary ax. These are exactly the surpluses that the majority of American voters would rather save to cover outstanding commitments to future retirees than use to fund additional tax cuts.

We must replenish the surpluses we use now to fight recession and the war on terrorism so that we can honor our future obligations to America's workers. Homeland security must come at the expense of their retirement security. Rescinding the income-tax and estate-tax cuts is the best way to make sure this doesn't happen. It's also the best way to restore the long-term credibility of the federal budget. As many observers—including Alan Greenspan, Robert Rubin, the Concord Coalition, and the Committee for Economic Development—have warned, without such credibility, upward pressure on long-term interest rates will impede the economy's recovery and long-term growth.

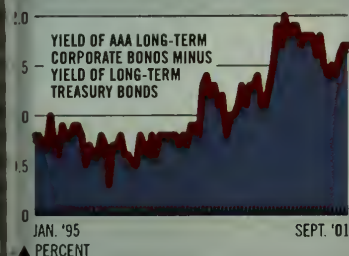
BY PETER COY

ARE CORPORATE BONDS A DEAL?

Not if the downturn deepens

The stock market has erased its post-September 11 losses, but bond investors seem to have a decidedly more pessimistic view of the future. The evidence? A big jump in the risk premium on corporate bonds—that is, the difference between corporate-bond yields and the yield on safer U.S. Treasuries. The

A SIGN OF FINANCIAL STRESS



risk premium for industrial junk bonds has widened B+ by Standard & Poor's has risen to six percentage points above Treasuries, vs. about 4.5 percentage points before the attack, as investors worry that the issuers will default. Even the least risky corporate bonds—the relatively scarce long-term bonds issued by top-rated borrowers such as General Electric Capital—have widened premiums that remain way above their historical average.

The spread between long-term bonds rated Aaa by Moody's Investors Service and 30-year Treasuries averaged 1.5 percentage points in September. By comparison, the spread was as low as 0.5 of a point in the mid-1990s. Last year, the spread got as high as two percentage points, which was the highest in at least 20 years (chart). It briefly narrowed this past spring and summer, but pessimism about the risk of defaults seems to be returning, says Michael McGroove, head of Econoclast Inc., a Dallas-based economic consultancy.

If the yield spread is wide when the economy is close to a bottom, buyers of corporate bonds can lock in high interest rates with little fear of default. But the real possibility of a deeper recession means that corporates may not be such a bargain after all. "We still

don't have a good handle on how successful the Fed will or won't be in turning this economy around," says Kenneth L. Hackel, Merrill Lynch & Co.'s chief U.S. fixed-income strategist. As a result, he warns, "it's not clear to me at all that wide does equal cheap."

EURO ECONOMIES GET IN STEP

So setting money policy is easier

Since the launch of the euro in January, 1999, the European Central Bank has struggled—its critics say unsuccessfully—to set appropriate interest rates for a currency bloc that includes fast-growing tigers such as Ireland and Finland as well as laggards such as Germany and Italy. A single, Europe-wide monetary policy was bound to be too loose for the fast-growth countries and too tight for the laggards.

But the central bank's dilemma may be getting easier as the economies of the 12 nations that make up the euro zone are behaving more alike. The difference in growth rates between the fastest-growing member of the euro zone and the slowest has narrowed from 8.1 percentage points in 1999 to about 3.4 percentage points this year. Similarly, inflation and unemployment rates across Europe are moving closer together. And wage levels and living standards in the poorer countries on the euro zone's rim are catching up with those in the richer nations.

To be sure, the economies of some euro zone countries, such as Germany, are less flexible and deregulated than those of others, such as Spain. Moreover, the narrowing of the growth gap has occurred in a less-than-ideal way: through a slowdown by the highfliers, rather than an acceleration by the sluggish countries. Still, whatever the reason, "more and more they are moving in the same cycle," says Kevin Gaynor, an economist at UBS Warburg in London. "This is what economic and monetary union was meant to make happen."

That doesn't necessarily mean that policymakers

will make the right monetary decisions, of course. On Oct. 11, the governing council decided to leave rates unchanged at 3.75% even though most business folk favored a reduction. "Wherever they come from, they still seem monetary hawks at heart," says Friedrich Heinemann, an economist with the Center for European Economic Research in Mannheim, Germany. "Convergence won't change that."

By David Fairlamb

NOT ALL MARKETS ARE SUBMERGING

Some small bourses are winners

In uncertain times, volatile emerging markets are generally poison ivy. Indeed, the Morgan Stanley Capital International Emerging Markets Index is down 22% year-to-date in dollars. "The world is a riskier place than it was Sept. 10," says Brian Gendreau, emerging-markets strategist at Salomon Smith Barney in New York. "No one wants to explain why they have Brazil in their portfolios."

Yet surprisingly, the only markets that have gained this year are also emerging ones. Each of the winners has its own story. Oil is behind the 34% rise in Russia's benchmark RTS Index. "Russia has a current-account surplus, a stronger currency, and it's a commodity producer," says Gendreau. South Korea's relatively strong performance—its Composite Index is flat year-to-date in dollars—reflects government efforts to boost local demand as export markets flag, among other factors. Slovakia's SAX index is up 27% in dollar terms this year, helped by expectations that MOL Hungarian Oil & Gas PLC will raise its 36% stake in Slovnaft, which is half the index, to over 50% says B. Scott Sadler, emerging-markets portfolio manager at Wachovia Corp. Asset Management. Other gainers in dollar terms are Costa Rica, up 11%; Jamaica, 13%; and Ecuador, 30%.

But even if an investor is lucky enough to pick the right emerging market, there's a problem. In the smaller markets, the capitalization is so low that "it doesn't take much to buy the whole thing," says Marcel Cassard, chief emerging-markets economist for Europe at Deutsche Bank in London. Conversely, it's hard to sell without moving the price—making it hard to get your money out.

By Julia Lichtblau

HOW EUROPE IS CONVERGING



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JAMES C. COOPER & KATHLEEN MADIGAN

EFFY PROSPECTS FOR A STRONG RECOVERY

Consumers will have enough gas to fuel a revival, but it won't be robust

U.S. ECONOMY

Is the stock market telling us something about economic prospects? After all, the broad Wilshire index of 5000 stocks is up nearly 13% from its low on Sept. 21, and historically the stock market turns up about six months before a recovery begins. Investors appear to be looking beyond the valley of a short and mild recession to a strong recovery on the other side.

So far, the mild recession part of that scenario is on target. The downturn will be limited by past rapid adjustments by businesses to inventories, capital spending, and payrolls, and by Washington's timely and aggressive policy actions. While worries about anthrax exposure will test consumer confidence, reports suggest that

consumer spending in the wake of the September 11 terrorist attacks is holding up better than expected. As Federal Reserve Chairman Alan Greenspan told Congress on Oct. 17, "All in all, I think we are looking at a situation that is nowhere near as bad as many of us might think it would turn out to be."

But the strong recovery part of investors' apparent outlook is still iffy. Greenspan quickly added that the economy "is also not exhibiting a snapback which has been typical of what happens when you get a major hurricane or natural disaster which breaks down the infrastructure."

KEEP IN MIND that mild recessions have tended to be followed by mild recoveries, the most recent example being the upturn from the modest 1990-91 downturn. In contrast, severe recessions tend to engender strong recoveries, because they generate overly sharp adjustments to inventories and the balance sheets of businesses and households, and they create a backlog of build-up demand that suddenly needs to be filled.

Consumers are the sector to watch, but the requirements for a powerful spending upturn by households is unlikely to fall into place anytime soon. Throughout the business cycle, household buying has been governed by two basic factors: the labor markets and the stock market. Support from both of those sources has been eroding all year. Household net worth is set to de-

cline again for the second year in a row (chart), and labor market weakness will extend well into the new year, eroding consumers' sense of job security.

The depth of this recession will very likely be determined by the size of the falloff in fourth-quarter gross domestic product. The initial readings do not look terribly dire, but the shock effects from the September attacks are creating some insurmountable math problems for fourth-quarter GDP. The plunge in September activity pushed many of the key measures that affect GDP to levels well below their third-quarter averages, especially consumer spending.

We now know that retail sales in September plunged 2.4% from August (chart). The only gains were on essentials, such as food, gasoline, and drugs. First of all, that means third-quarter real consumer spending, as it goes into the GDP data, appears to have risen at an annual rate of 0.5% to 1.5%, down from 2.5% in the second quarter. The lower

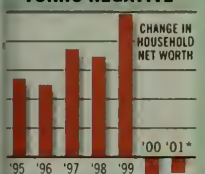
end of that wide range incorporates a heavy hit to outlays for services, such as air travel and hotels. Given the trends in other GDP components, economic growth in the third quarter, due to be reported on Oct. 31, seems likely to have declined, probably in the range of -0.5% to -1.5%.

Second, the September sales drop means that consumer spending in the fourth quarter will post an outright decline. How large? Consider two paths: Even if outlays return to their pre-September growth rate—a very optimistic assumption—real spending will still decline at an annual rate of -0.5% to -1%. If spending stays flat at its weak September level, real outlays will fall at a rate of -2.5% to -3%.

GIVEN THAT OCTOBER SPENDING appears to have picked up, a drop in fourth-quarter GDP in the -1% to -2% range seems a reasonable outcome, against a backdrop of continued weakness in business outlays and exports and a topping out of housing activity. September housing starts rose 1.7% from August, but single-family building activity has weakened since April.

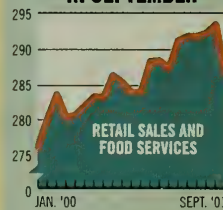
The fourth-quarter outlook could have been a lot worse. But early October data indicate that consumer

THE WEALTH EFFECT TURNS NEGATIVE



BILLIONS OF DOLLARS, ANNUAL CHANGE THROUGH SECOND QUARTER
Data: Federal Reserve Board

CONSUMERS STAYED HOME IN SEPTEMBER



▲ BILLIONS OF DOLLARS
Data: Commerce Dept.

confidence rebounded a little from late September, based on a University of Michigan survey. Early reports from auto dealers show surprisingly strong sales, although handsome incentives may have "borrowed" sales from future months. And in retailers' first fiscal week in October, sales rebounded somewhat, says Instinet Research Redbook.

Ultimately, consumer confidence boils down to prospects for jobs and income, and sentiment could take a hit in coming months as the jobless rate rises. True, weekly jobless claims fell after their September surge, but they remain well above the trend of 400,000 or so prior to the attacks. Even the pre-attack level was consistent with falling payrolls, and the current claims data imply that a sizable increase in the unemployment rates will grab the headlines when the Labor Dept. releases its October job report on Nov. 2.

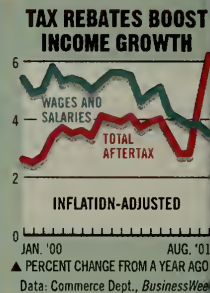
LOOKING FURTHER OUT, consumer spending will be limited by soft labor markets and the adjustment to declining wealth. To be sure, tax rebates this year and more cuts next year will support consumer incomes, but weaker labor markets are already pressing on income growth (chart). Since the end of last year, the yearly growth of income from wages and salaries, adjusted for inflation, has faltered from 5.5% to 3.5%, and it will slow further in coming months as job losses continue.

Moreover, absent a rapid resurgence in profitability,

which seems unlikely, businesses will not return their exuberant hiring practices of recent years. With new attention to the bottom line, companies will extract all possible productivity gains from their slimmer workforces before adding people. That pattern would be similar to the recovery from the 1990-91 recession.

Another important challenge facing households is the new reality of diminished wealth. Through the second quarter, household net worth was already down \$532 billion from yearend 2000, after posting a loss of \$875 billion last year, according to Federal Reserve data. Based on the mid-October level of the Wilshire 5000 index, net worth is down by an estimated \$1.5 trillion to \$2 trillion from the end of last year. Reduced wealth means that households will feel the need to boost their savings next year, which will leave less room for spending to rise.

Next year, look for consumer outlays to increase more in line with the pace of incomes. That means growth in the neighborhood of 3%. Compared with go-go years of the late 1990s, when spending was climbing in excess of 5% per year, that's hardly stuff of powerful recoveries.



EURO ZONE

NO RATE CUT TO TEMPER THE DOWNTURN

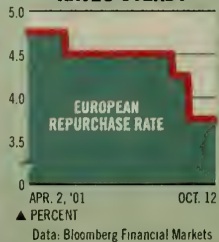
The European Central Bank disappointed investors and euro zone workers on Oct. 11. The bank declined to cut interest rates despite growing evidence that the euro slowdown is worsening.

In a statement, ECB president Wim Duisenberg said that the bank did not want to appear "panicky" and that the recent surge in M3 money supply, although partly caused by temporary factors, needed "to be monitored carefully in the coming months." That might be a hint that the ECB will not cut again in the autumn.

The bank had followed the Federal Reserve in trimming rates on Sept. 17 after the terrorist attacks. That was the third cut this

year, pulling the target repurchase rate down to 3.75% (chart). But analysts had been hoping for more aggressive action, since inflation continues to slow and economic growth is faltering.

POLICYMAKERS HOLD RATES STEADY



are not encouraging about third-quarter growth. Private economists expect the euro zone to grow about 1% in the second half.

But the ECB remains more worried about inflation than growth,

despite better news on the price front. In August, euro zone inflation stood at 2.7%. While still above the ECB's 2% target, it was the third consecutive month of improvement. And the recent decline in energy costs as well as slowing demand suggest inflation will slip lower in coming months. Already, France has reported that September consumer prices rose only 1.6% from the year before.

Despite that, the bank for now is holding its ground about rate cuts. Policymakers hope that structural changes in public finance, labor markets, and distribution have set the stage for stronger growth in 2002. But with the U.S. in recession and the monetary future so unclear, the ECB is taking a risk by not giving the euro zone some insurance against a recession of its own.

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business software

IT'S A DIFFERENT KIND OF WORLD.
YOU NEED A DIFFERENT KIND OF SOFTWARE.

WHAT TO DO ABOUT OIL

Here's how the U.S. can reduce its dependence on Mideastern crude

For months, America's energy debate seemed like little more than a sparring match pitting conservatives against liberals. Republicans rallied around President Bush's call for a dramatic boost in production. Democrats asserted with equal fervor that White House plans to drill in wilderness areas would pillage the environment and provide a windfall for oil companies. The answer, they insisted, is conservation.

Now the dialogue is being transformed by the September 11 attacks on the U.S. and by Bush's declaration of a long and unrelenting war against global terror networks. The country still relies on OPEC for 51% of its imported crude. But Saudi Arabia and other Middle East oil-producing nations may be destabilized as a byproduct of U.S. military intervention and the backlash it sows in the form of Islamic fundamentalism (page 34).

"A VERY TALL ORDER." Indeed, what to do about U.S. reliance on Saudi oil is suddenly an issue that's front and center in Congress and at the White House. "Our country needs greater energy independence," said Bush, pushing his stalled energy plan in an Oct. 17 speech to Sacramento business leaders. "This issue is a matter of national security and I hope the Senate acts quickly."

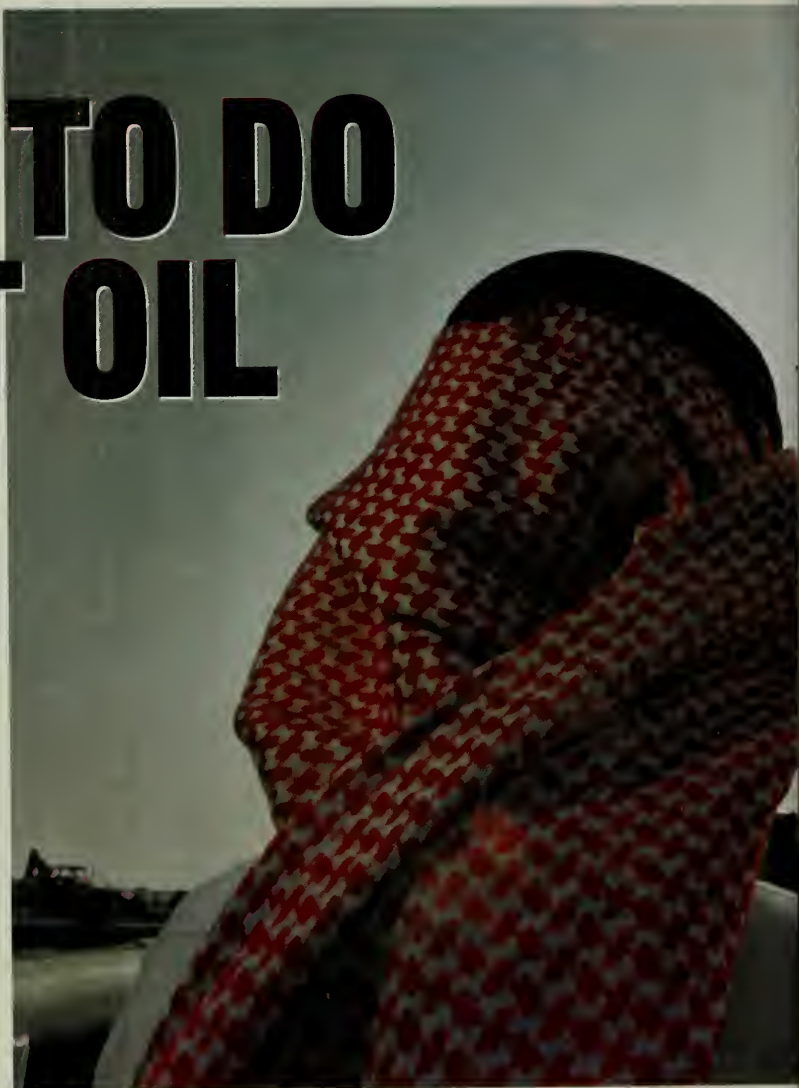
But with the energy conundrum now tougher than ever, the Administration—along with the country at large—may need to rethink long-held positions. If the events of September 11 suddenly infused the energy debate with a new im-

portance, they also deepened the economic slowdown against which that debate is occurring. Reeling from 12 straight months of declining industrial production and the psychological blow of the September 11 terrorist attacks and the anthrax scare, the ailing economy can't tolerate short-run solutions that would dramatically raise energy costs or further weaken consumers. An energy policy that takes economic weakness into account "is a very tall order," says David M. Nemtsov, president of the Alliance to Save Energy, a broad-based Washington group that promotes energy efficiency. "If it was free and good for the economy, it would have happened already."

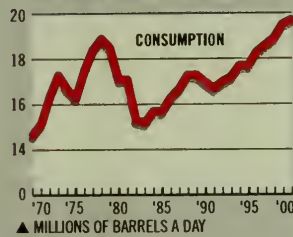
Even amid the slowdown, energy markets are fragile. While the global economic downturn has depressed demand and kept oil prices at a modest \$22 a

barrel, the U.S. is more vulnerable to an oil-shock than it was during the 1973-74 Gulf War, when prices soared to \$40 a barrel. Back then, there were 5 million barrels a day of excess capacity worldwide. Now, that figure is about 50% lower due to U.S. curbs on energy investments in Libya and Iran and tight national budgets in oil-producing nations. "If something were to happen today, it would be more serious," warns Amy Myers Jaffe, senior energy advisor at the James A. Baker III Institute for Public Policy in Houston.

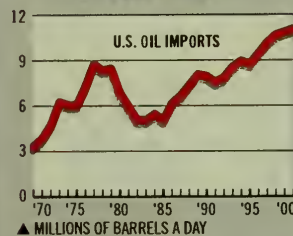
The high-wire balancing act of weighing long-run energy policy against the current needs of the economy is putting pressure on policymakers to tone down the rhetoric. Moreover, it's shifting the focus. While an overall rethinking of energy policy that goes beyond oil to enco-



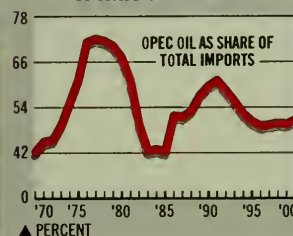
AS DEMAND FOR OIL IN THE U.S. SOARS...



...IMPORTS HAVE SURGED DRAMATICALLY...



...AND RELIANCE ON OPEC REMAINS HUGE



Data: Energy Information Administration

ss a re-evaluation of nuclear energy, coal, natural gas, and alternative energy sources—along with broader conservation moves—remains important, the critical emphasis now is on oil. In fact, that's because the aftermath of the terrorist attacks has made clear that the risks of destabilization in the Middle East will remain sharply higher for the foreseeable future. And U.S. vulnerability to an oil shock is increased by the fact that oil accounts for 75% of the nation's energy needs, is critical to transportation, and, for most uses, can't be substituted for with other types of energy.

What should Washington do? A simple energy-use tax would raise the price of

SAUDI SUPPLIER

The U.S. needs to move rapidly to forge closer ties with oil producers outside the Middle East

oil, penalize inefficiency, and work to drive down demand. But a new energy levy that would sock already-strapped consumers is a political non-starter with the economy heading downhill.

That doesn't mean lawmakers are powerless to address the problem. Among the ideas to consider: dramatically expanding the Strategic Petroleum Reserve as a hedge against future supply disruptions, moving aggressively to diversify sources of oil imports, boosting domestic production, and promoting new technologies. While these steps may be incremental, "small changes can be important in terms of affecting the pricing power of OPEC," notes Ronald B. Gold, vice-president of the Petroleum In-

dustries Research Foundation. Indeed, a wide range of options are now under consideration:

***Up The Strategic Reserve** The reserve now holds about 544 million barrels of oil—a 60-day supply. That's well shy of its 700-million-barrel maximum, and some lawmakers, such as Representative Joe Barton (R-Tex.), want to expand it to one billion barrels. Although it could cost up to \$6 billion to reach that level, with oil prices relatively low, now would be a good time to fork over the cash. "The more oil you have access to, the more leverage you have in a global market," says Red Cavaney, president of the American Petroleum Institute.

***Diversifying Imports** Although it could be expensive, the U.S. needs to move rapidly to forge closer ties with oil producers outside the Middle East to diminish dependence on the unstable region. And in truth, America already has made substantial progress. Today, the U.S. imports 51.6% of its oil needs and relies on OPEC for about half of that—roughly 26% of total consumption. That's down from 33.6% in 1977, but more than double what it was in the mid-1980s. Today, Canada, Mexico, and Venezuela each supply the U.S. with roughly as much crude as Saudi Arabia, the world's top producer. And over the long term even Russia could help (page 32). There are also vast pools of as-yet-untapped oil in Angola, Nigeria, and Chad, says H.J. Longwell, executive vice-president of Exxon Mobil Corp. However, "bringing these projects to fruition will require huge new investments," he says.

Moreover, drumming up new sources of oil is made vastly more complicated by the sometimes-conflicting goals of the U.S. government and U.S. oil companies. The government wants stable sources above all else. Oil companies want to go wherever crude can be gotten relatively cheaply, despite political risk. The energy plan Bush and Vice-President Dick Cheney unfurled this spring, for instance, calls for reinvigorating multilateral U.S.-African panels to promote investment in the region's energy resources. But the major oil companies prefer places with low extraction costs, such as Iran, Libya, and Saudi Arabia. That clashes with any drive to reduce reliance on the region.

***Boost Domestic Drilling** The U.S. is the most reliable oil source of all, of course. But as energy demand surged 17% during the 1990s, domestic oil production rose by just 2%, forcing America to rely more heavily on imports. Oil experts believe there are 6 billion to 16

billion barrels of untapped oil in the Arctic National Wildlife Refuge of Alaska, and another 4 billion in the lower 48 states. And with advanced technology, 59 billion barrels of oil may be available off U.S. shores. But environmental restrictions and local opposition have barred such development. Says Robert J. Allison Jr., chairman of Houston-based Anadarko Petroleum: "We are shooting ourselves in the foot."

The tensions unleashed by September 11 and the ensuing Afghanistan war are giving new urgency to decades-old domestic squabbles. "No amount of domestic production will keep us free of foreign sources of oil," insists Tyson Slocum, energy research director for Public Citi-

zen, a consumer group founded by activist Ralph Nader. Even Bush's brother Jeb, the conservative governor of Florida, has fought offshore drilling, though he may soften that position.

One way around the environmental debate could be the advent of new drilling technology that's far less invasive. "We're not talking about raping the environment," says Allison. The public may be receptive to such moves. According to a poll conducted Sept. 15-17 by Wirthlin Worldwide, a GOP polling firm, 38% of Americans say "protecting our national security" is the most important reason for a comprehensive energy plan, up from 19% in July.

***Improve Auto Fuel Efficiency** It's a

lot easier to get consumers to curtail energy consumption when they're faced with high energy prices, as in the 1970s and in California during its recent electricity crisis. With energy prices relatively low, consumers have little incentive to change their habits. Still, the new environment appears to have increased the willingness of the Administration and Congress to support a phasing in of tougher fuel-efficiency standards for passenger vehicles, which account for nearly half of oil consumption. And by spreading out any increases over a number years Washington could minimize the negative impact on the economy.

Such a move would reverse a serious erosion in fuel-efficiency wrought by the

RUSSIA: HOW MUCH OF A RESERVE TANK?

Four months ago, when President George W. Bush met Vladimir V. Putin for the first time, he looked into the squinty blue eyes of the spymaster-turned-Russian president and said he "was able to get a sense of his soul." Now, in the wake of the terrorist attacks on America, the love fest between Russia and the U.S. is heating up. Putin immediately denounced the terrorists, said he would allow the U.S. to conduct humanitarian flights from Russia, and gave a nod to the stationing of U.S. troops in neighboring Uzbekistan, a former Soviet republic. And in a speech to German industrialists in Essen on Sept. 26, he made a surprising offer. "In case of regional conflicts breaking out, Russia is prepared to supply more oil," Putin said. "And I say this loud and clear."

No question, Russia can pump up production. In the past three years, oil companies have spent billions modernizing their facilities. This year Russia will produce 7 million barrels a day, 13% above 1999, and second only to Saudi Arabia, whose daily output is 8.4 million barrels. Russia could hike output by 4% next year, estimates United Financial Group, a Moscow brokerage. Some are even more optimistic. "Russian oil is a standby reserve," says Mikhail B. Khodorkovsky, CEO of Yukos Oil Co., Russia's second-biggest producer. "Russia could increase pro-



BOOSTING THE BARRELS

BALTIC SEA A new pipeline stretching from Russia's Timan-Pechora region in north Siberia to the port of Primorsk on the Baltic Sea will be completed by the end of the year.

CASPIAN SEA The first pipeline dedicated to crude from the oil-rich Caspian basin, 15% owned by ChevronTexaco and stretching about 1,000 miles from the Tengiz field in Kazakhstan to the Black Sea port of Novorossiysk, started operations on Oct. 15. On the drawing board is a pipeline that would run from Azerbaijan across Georgia and Turkey to the Mediterranean port of Ceyhan.

duction by 10% to 15% a year ea

That could substantially reduce risk to the U.S. and Western Europe a disruption in supplies from the M East—provided the oil can reach t markets. Russian exports are runn 2.8 million barrels per day this year

22% increase over 1 But that remains no near the 7.1 million rels a day exported Saudi Arabia. Thou

WESTERN SIBERIA Producers in Russia traditional oil patch ramping up production and exports.



ge popularity of SUVs. A new Environmental Protection Agency report shows that cars and SUVs last year had the lowest average gas mileage since 1980. The average mileage in 2000 was 24.2 mpg for cars and 17.3 mpg for SUVs. That's far below the standards vehicles are currently supposed to meet: 25.5 mpg for cars and 20.7 mpg for light trucks. If light trucks, which include SUVs, had to meet the required level for cars, that would save a million barrels of oil a day, according to the Alliance to Save Energy.

Federal intervention may be needed because there is little market incentive to make or buy less-thirsty vehicles. The federal tax credit could help kickstart a market by encouraging use of hybrid cars, which combine gas engines and electric motors and can cut fuel consumption by as

much as 40%. Indeed, the House-passed energy bill includes tax credits for buying hybrid autos. Such incentives would give a much-needed boost to the nascent hybrid market. Toyota Motor Corp. and Honda Motor Co. already sell hybrids that get 48 mpg and 56 mpg, respectively. General Motors Corp. and Ford Motors Co. plan to launch their models in 2004, but they are expected to be less efficient.

One day, many experts believe, the auto industry could virtually wean itself completely from fossil fuels with so-called fuel cells that use hydrogen. But that day is at least 20 years away. To speed the process, some would like Washington to embark on a crash R&D program on alternative energy technologies. Says David Orr, chief economist for Wachovia Corp. in Charlotte, N.C.: "So far, fuel cells and

other technologies haven't gotten the emergency allocation that a war might bring about."

Will any of this come to pass? Much depends on whether politicians can lay aside ideological differences and forge a consensus to bolster security by reducing dependence on foreign oil. It will be a test for both the White House and Congress to see whether the current collegiality extends to something as contentious as a national energy policy. But as the bombing campaign rages on in Afghanistan and the specter of instability in the Middle East grows, Washington has little choice but to try.

By Laura Cohn and Stan Crock in Washington, with Peter Coy in New York, Stephanie Anderson Forest in Dallas, David Welch in Detroit, and Christopher Palmeri in Los Angeles

could hike exports by 500,000 barrels a day by December, it would hit the rest of its pipeline system. That's a big help to the U.S. greatly in a emergency. New pipelines on the Caspian Sea boards could up Russia's capacity by 2.5 million barrels a day. "They won't be ready until 2004," says G. Kukes, president of Tyumen Oil Co. "There is a long way to go," adds G. Kukes, president of Tyumen Oil Co. "There is a long way to go," adds G. Kukes, president of Tyumen Oil Co. "There is a long way to go," adds G. Kukes, president of Tyumen Oil Co.

lem. Most of the country's oil is produced in Western Siberia, thousands of miles away from ice-free ports that have oil-export capability. Oil must go by pipeline to Western Europe, or to tankers that can carry it to the U.S. or other markets. Transneft, the state-owned pipeline monopoly, can export 3.3 million barrels a day, but it's carrying all it can. Many oil companies don't produce at full capacity since they can't get more pipeline space.

PIPELINE RACE. Even so, Russian producers are racing to boost drilling. Oil companies have tripled capital spending, to \$6.5 billion since 1999. The Russian government is also doing its bit, by cutting rates on corporate profits from 35% to 24%.

More critical is the race to build new pipelines to ports in both Russia and its neighbors near the oil-rich Caspian Sea. Kazakhstan is expected to become one of the world's major oil producers in the next decade, and has received \$10 billion in foreign investment since independence in late 1991. Azerbaijan, Uzbekistan, and Turkmenistan also have large reserves. "Central Asia will become a much more important region," says Daniel Yergin, chairman of Cambridge Energy Research Associates. "Certainly this new relationship between Russia and the U.S. will facilitate development of resources."

The first pipeline to transport Caspian oil overseas began operating on Oct. 15. The Caspian Pipeline Consortium, whose shareholders include ChevronTexaco,

spent \$2.5 billion on the pipeline, which stretches about 1,000 miles from western Kazakhstan across southern Russia to the Black Sea port of Novorossiysk. Also in the works is one that would run from

Azerbaijan across Georgia to the Mediterranean port of Ceyhan in Turkey.

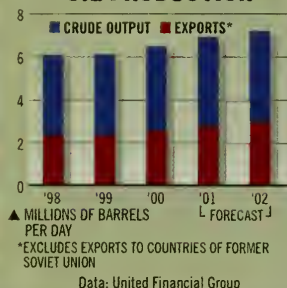
Thousands of miles north, the first stage of the new Baltic Pipeline System will be done by year-end. Stretching from Russia's Timan-Pechora region to Primorsk on the Baltic Sea, it will add 240,000 export barrels a day. A number of oil majors, including Exxon Mobil

Corp., are exploring deposits off Russia's Sakhalin Island near Japan, where crude reserves estimates run more than 8 billion barrels. Japan is a natural market, but it's also a straight shot for tankers to the U.S. West Coast.

Still, it will be three to five years before major new amounts of Russian oil hit foreign markets. "I see Russia's oil production increasing, and as it does, I'm sure some of it will make its way to the U.S.," says Commerce Secretary Donald Evans, who was on an official trip to Russia last week. "It won't necessarily happen because of Afghanistan. It will happen because that's the way the market will work." But if Middle East oil is disrupted, Bush's new buddy Putin could make sure Russia sends as much oil as it can to the West—now.

By Anna Raff in Moscow and Patricia Kranz in New York, with Christopher Palmeri in Los Angeles

RUSSIA PUMPS UP OIL PRODUCTION



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COMMENTARY

By Stanley Reed

GET TOUGHER WITH SAUDI ARABIA—BUT QUIETLY

One of the casualties of the September 11 attacks on New York and Washington may well be America's relationship with Saudi Arabia, the world's largest oil exporter. Elements of both the U.S. media and the U.S. government are incensed at the Saudis' reluctance to cooperate with the American military or aid the investigation of the attacks. Several hijackers were probably Saudis and the prime suspect, Osama bin Laden, is a native

ken \$10,000, versus \$1,000,000 for cargoes coming from Iraq. Oil prices are at their 20-year average of just over \$22 per barrel.

But the U.S. cannot let the situation in Saudi Arabia drift. The Bush Administration must decide just how much to press the Saudi royal family to cooperate with its antiterrorism campaign. Pushing too hard could rattle the Kingdom. Over time, the U.S. has to rethink its overall policy. For too long the U.S. has backed a

Washington's best shot at obtaining cooperation is to keep its conversations private. Even then the Saudis will be wary because the investigation is likely to reveal embarrassing details on the Kingdom's misdeeds, laxity, and complicity with regard to funding and otherwise supporting Islamic extremism. Only on Oct. 1 did the Saudi government order banks to check for dealings with suspected terror groups. It has yet to freeze a single bank account, according to

U.S. sources.

In the longer run, the U.S. needs to bolster support for reform-minded princes in the royal family such as Crown Prince Abdullah. He has been largely running the country in place of his ailing half-brother, King Fahd, but is caught in infighting with Fahd's full brother, Defense Minister Prince Sultan. Some princes even say privately that the royals need to be gradually eased out of government. The U.S. should put its weight behind the princes and technocrats who want economic

liberalization and a gradual political opening of the country.

The U.S. should also urge the royal family to curb the corruption that has damaged their image. Even their own people are aware of the admission by the Saudi Ambassador in Washington, Bandar bin Sultan, that corrupt Saudis may have siphoned off as much as \$50 billion of the \$400 billion spent on development.

None of these changes will be easy. The Saudi need for protection from the likes of Saddam Hussein provides some leverage for the Bush Administration. But the Saudis, who have spent billions for American arms, don't take kindly to direction from Washington. With luck, the Americans and the Saudis will ride out this scary period. Without major changes, though, their relationship is destined for strife.

Reed covers the Middle East.



RUMSFELD IN RIYADH: The U.S. needs to back reformers

of the Kingdom. Saudi inaction is sparking fears about the stability of the Kingdom and about the security of its unmatched oil reserves. Concerns are growing that the Saudi regime has fostered terrorism by turning a blind eye to the activities of Islamic extremists.

Yet for now, fears of far-reaching instability in Saudi Arabia are exaggerated. The Kingdom is far from a collapse resembling that of Iran 20-plus years ago. True, there have been a few worrying incidents, such as a suicide bombing that killed an American in the city of al-Khobar on Oct. 6. But Saudi analysts and long-time residents say the atmosphere is relatively calm. And the marketplace thinks the Saudi oil supply is secure. The war-risk insurance premium for tankers loading at the main Saudi terminal at Ras Tanura is only a to-

ken leadership that is widely perceived to be corrupt and allows so little political expression that the only outlet for dissent is religious extremism.

BIG STAKES. Part of the reason for the House of Saud's half-hearted cooperation with the Bush Administration is its worry over Osama bin Laden. His charges that the royal family has betrayed its Islamic foundations have found a good deal of sympathy among Saudis. That has the leadership caught between trying to accommodate their American protectors and keeping a lid on popular wrath. "This is one of the greatest threats the Saudi royal family has faced in the last twenty years," says Simon Henderson of Saudi Strategies, a London consultancy. "If they muck this up, they could lose [their hold on power]."

In time-honored fashion, the Saudis are trying to maneuver through this mess by treading cautiously.

STRAINS ON THE RELATIONSHIP

LIMITED MILITARY COOPERATION

The Saudis won't allow American planes to fly bombing missions from their bases

LINKS TO TERRORISTS

The U.S. believes Saudi citizens finance Osama bin Laden and other extremists

POLICY DISAGREEMENTS

ON ISRAEL U.S. support for Israel weakens the Saudis' ability to back America in the anti-terrorist war



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COMMENTARY

By John Carey

VACCINE RESEARCH NEEDS A SHOT IN THE ARM

When much of the Capitol was shut down because of the threat of anthrax, many Americans were left wondering what could be next. Smallpox? Plague? Ebola virus?

In a nation that read the human genetic code, you would think it would be possible to get vaccinated against anthrax and these other potential scourges. But you can't—the vaccines just aren't available. As for treating the most deadly inhaled anthrax infections, there are fears the antibiotic Cipro could soon be in short supply. The Bush Administration is responding with a \$1.5 billion proposal that includes boosting the nation's stockpiles of antibiotics for anthrax sixfold and accelerating production of smallpox vaccine, the only treatment for smallpox.

These steps are not enough, however, especially on the vaccine front. "Medicine has no better way of preventing diseases" than vaccines, says industry veteran Dr. Stanley A. Plotkin, professor emeritus at the University of Pennsylvania. "If you start from that recognition, we need to promote their development and production."

OLD DESIGNS. The basic problem is that vaccines—despite their stunning successes against scourges such as polio, smallpox, and yellow fever—have been a poor stepchild to drugs for the pharmaceutical industry. Thus, most are decades old—at a time when the supporting science is undergoing a revolution. The current anthrax vaccine, for instance, is a 40-year-old design laden with impurities that cause reactions. It's not even proven to prevent the inhaled version of the disease. "We now know how to make a better vaccine," says Dr. Thomas P. Monath, research chief at Acambis, a British biotech company making smallpox vaccine.



POSTAL PRECAUTION: An Emergency Services officer collects mail in New York

With today's genetic wizardry, scientists can read the genetic code of pathogens and determine which parts might best

stimulate the immune system to fight the bugs. "Any lab in the field can select the pieces and stuff them into a known safe vaccine, inject it into a mouse, and get it to neutralize anthrax," says Andrew McMichael, director of Oxford University's Institute of Molecular Medicine.

The smallpox vaccine is one that needs improving. The U.S. stopped vaccinations for the general public in the early 1970s, because the risk from the vaccine was greater than the risk of the disease. Today, it makes sense to use it only during an actual epidemic. But a safer product could be given to everyone—neutralizing smallpox as a bioterror weapon.

Developing better vaccines costs big bucks. "Who will invest \$100 million for development

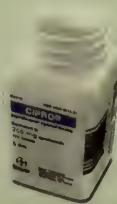
if there's no market?" asks Monath. "That is where the government has to step in." The good news is that vaccine development for Third World diseases is getting a \$1 billion-plus boost from foundations. Research fueled by a similar amount from the federal government could piggyback on the innovative ideas being spawned, as well as on the vast expertise in big pharmaceutical companies. Congress also needs to expand a 1986 law that provides compensation when children are proven to be harmed by vaccines. It will reduce the chances of manufacturers being driven out of business by lawsuits.

Of course, vaccines are only part of the answer. If rogue scientists create a diabolical genetically engineered virus, even a crash program to develop a vaccine would take months—too late to quash an epidemic. That's why vaccine experts say another crucial piece of the puzzle is tackling lethal germs at their source. "We need to make sure that the Russian stockpile of biological agents is contained or destroyed," explains Dr. Harry L. Keyserling of Emory University, "and that scientists involved in their biological warfare campaign don't use their skills for countries that might foster terrorism."

Under President Clinton, the government began pumping hundreds of millions into measures to thwart bioterrorism, including restarting smallpox-vaccine production. Now, we need to step up new vaccine development—which will also help to tame other diseases around the world. Today's anthrax-laden envelopes may seem scary. But we faced far graver dangers from diseases like polio and smallpox just half a century ago. New vaccines solved the problem then. They're a big part of the solution now.

With Heidi Dawley in London and Amy Barrett in Philadelphia

Cipro gets all the attention, but new vaccines are a better solution



HARRY LINDSEY ON BAILOUTS, ANTHRAX, AND THE SLUMP

Washington's economic guru sees delays in a V-shaped rebound

Since September 11, White House economic coordinator Lawrence B. Lindsey has kept a low profile. But National Economic Council has guided continuous assessments of the economic fallout and played a key role shaping bailouts for New York City, airlines, and the insurance industry. Oct. 17, Lindsey talked with Washington Bureau Chief Lee Walczak.

...ines and, soon, insurance companies, are in line for federal aid in the wake of the terrorist attacks. ...the list end ...e? ...here's only been ...industry [bailed ...], and that's air- ...s—which were shut ...n...to get control ...he skies. This pre- ...tated a tremendous ...of revenue. The ...cal thing [was to] ...vide assistance.

...aren't you also ...ing to help insurers ...assuming much of ...risk of future ter- ...st-based losses? ...insurance companies ...paying more than ...billion to meet the ...ms of 9/11. There ...ow an inability to estimate the cost ...t future incident, which [prevents] ...ing of risk. If you can't do that, the ...ket collapses.

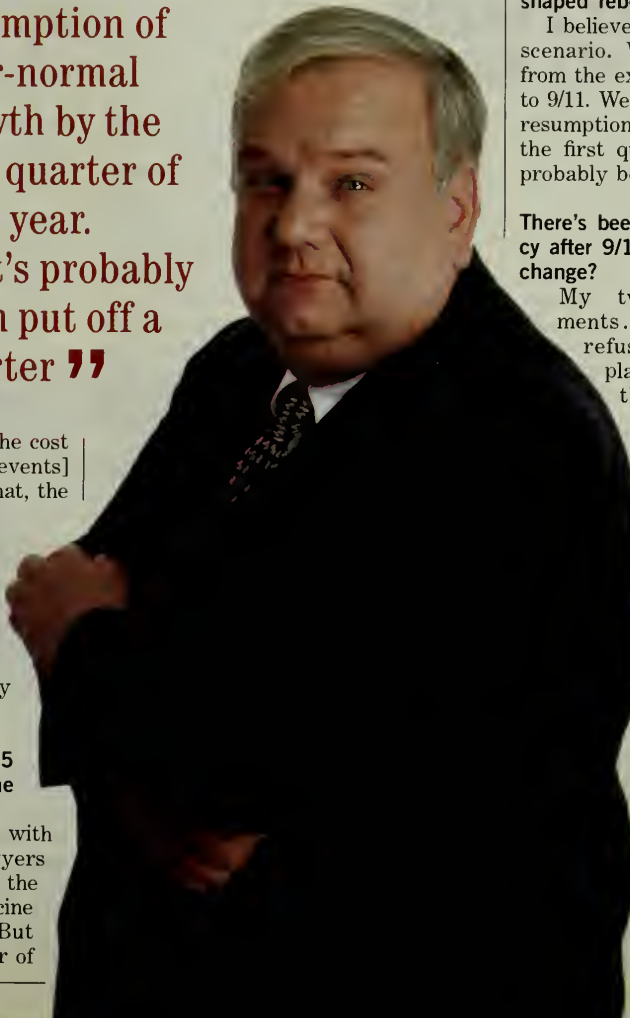
...en the anthrax scare, will ...beef up the public health ...em? ...t is something we are pro- ...ng more funds for as part of ...[initial] \$40 billion emergency ...package. ...n't you also requesting \$1.5 ...on more for vaccine ...duction? ...es. And one of the problems with ...e production is...trial lawyers ...[o] are threatening to sue in the ...of anyone who gets a vaccine ...has an adverse reaction. But ...any vaccine, a small number of

people will have an adverse reaction. Unless there is some liability cap on the rapaciousness of these individuals, the drug companies cannot prudently go forward....The trial bar is the major threat to the resumption of sound economic activity...and to public health.

Why is it taking so long to come up with a bipartisan economic stimulus package?

[Smiling] This is just a small Southern city. This is normal slow Southern pace. The [\$75 billion] package the President has suggested is one that both parties can live with. As for timing, the first tax bill got passed

“We probably would have seen a resumption of near-normal growth by the first quarter of next year. That’s probably been put off a quarter”



in four months. That was record time, and we're talking about something like four to six weeks for this tax bill. This is lightning speed by Washington standards.

Have differences between Democrats and Republicans been resolved over business tax breaks?

Well, the President asked that [they] be made permanent. The House [Ways & Means Committee] passed a temporary measure for three years. That's [still] enough to get the provision in place. Anyone who buys new equipment over that period will get more generous depreciation.

Critics of business breaks say you should be focusing more on stimulating consumer demand. Your response?

The main problem is increased risk-aversion on the part of households and firms. The standard economic answer for that is exactly what's being proposed: Lower the cost of investment.

With all of this stimulus, what do you feel the prospects are for a strong, V-shaped rebound next year?

I believe V-shaped is the most likely scenario. We contained the damage from the excesses of the Nineties prior to 9/11. We probably would have seen a resumption of near-normal growth by the first quarter of next year. That's probably been put off a quarter.

There's been a lot of rethinking of policy after 9/11. How should energy policy change?

My two greatest disappointments...are that the Senate has refused to take up an energy plan and trade-promotion authority. To me, the energy plan would be a natural response to what happened. But we have bottled up the package. The reasons have nothing to do with the national interest, but with politics.

How confident are you that the economy is on the mend?

There is increased uncertainty and risk aversion. [But] as we triumph over the terrorists, the world will become a safer place.

BusinessWeek online

For an extended version of this interview, please go to www.businessweek.com



MASSIVE DAMAGES Casualty carriers aren't balking at claims for September 11 but want to sidestep future risks

the next \$80 billion. In years two and three, insurers would be responsible for larger shares of the cost. Even if the next three years are disastrous, the industry's exposure is capped at \$80 billion. "This plan can be sold at Capitol Hill as short-term emergency relief, just like food and blankets for flood victims," says analyst Steve Blumenthal at Schwab Capital Markets.

NO STRINGS. The White House also insists that three years is the right time frame for shoring up the industry. That should allow underwriters to assess the real cost of terrorism and adjust premiums. And it will allow

them time to set up private reinsurance pools for future coverage.

There's only one problem: The Administration isn't asking underwriters to pay anything for this new terrorism coverage. But the government should charge insurers premiums for it, so that over time, insurers will reimburse the U.S. Treasury for any costs. That could be done by charging small premiums in coming years to all businesses, spreading the costs out broadly, and over time. The result: Industry would get coverage it needs without being forced to raise rates to crippling high levels while business, rather than the taxpayer, would foot the bill.

Such an arrangement wouldn't require a large bureaucracy or federal

regulation. "Three agencies in a room could come up with a premium plan," says Robert Hunter, director of insurance for the Consumer Federation of America. He did just that as director of the U.S. Riot Reinsurance Program, which brought insurers back to the cities after the urban pillaging of the 1960s.

The best model could be the Federal Deposit

Insurance Corp. Individual banks have over the years paid small premiums to cover all banks against enormous potential losses. The FDIC, like any good insurance plan, spreads risks instead of ducking them. Terror risks should be covered the same way.

By Diane Brady in New York and Mike McNamee in Washington

UNDERWRITING

GIVE INSURERS A BREAK —BUT NOT A FREE RIDE

Uncle Sam should levy charges for the three-year prop-up plan

War is hell, old soldiers say. And it's no picnic, either, for a White House that started out to be free-market and anti-government. Now, chalk up insurance companies on the growing list of industries that are casting a hopeful eye at federal coffers. Although property-and-casualty insurers aren't balking at paying the estimated \$40 billion tab for the September 11 attacks, they're threatening not to renew coverage for businesses they consider at risk from terrorism. In response, on Oct. 15, President George W. Bush proposed propping up the industry to the tune of as much as \$229 billion over three years. Instantly, the industry breathed a collective sigh of relief. "This protects us for a while," says Chuck Clarke, chairman and CEO of Travelers Property Casualty Corp.

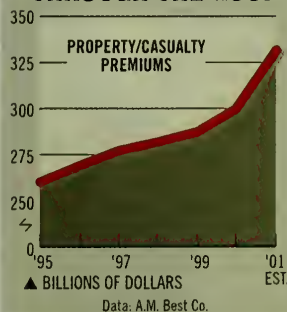
Clearly, insurance companies are in a tight spot. States, which regulate the industry, require underwriters to provide terrorism coverage, and will likely continue to do so. But the industry contends that it has no choice but to either forgo offering such coverage to businesses it considers an undue risk, or charge such exorbitant rates as to be prohibitive. The reason: reinsurance companies, which back up their policies, say they'll cut off terror insurance on Jan. 1, when trillions of dol-

lars in policies expire. That could prompt underwriters to balk at writing policies altogether because they don't want to be left holding the bag. With no coverage, lenders won't lend, builders won't build, and business will grind to a halt.

The Bush Administration wants to avoid that frightening scenario—but is it giving away too much? Insurance companies are currently sitting on a \$130 billion pool of capital for commercial losses. Even after paying for the September 11 attacks, most of that money will still be available. But the Bush plan would put the Treasury on the hook for most terrorism damage in the next three years: Up to \$88 billion in 2002, if claims hit \$100 billion, and another \$141 billion in 2003 and 2004.

The Administration argues the plan is fair for everyone: It helps insurers handle coverage of any terrorism over the next three uncertain years. In return, it requires the industry to share the burden with taxpayers: In year one, the government would pay 80% of claims on the first \$20 billion in damages, and 90% on

THROUGH THE ROOF



ERSEY CITY: WALL STREET WEST'

er September 11,
ranks of businesses
oping the Hudson swell

he nickname "America's Golden Door" never really caught on. So Jersey City officials tried to tag town "Silicon Valley East"—then Internet Revolution petered out. The latest monicker for Manhattan's hbor across the Hudson—"Wall et West"—just might stick.

fter all, 32,000 displaced World Trade er area employees are now stream- nto Jersey City daily. Suddenly, Wall et-types are wondering about Hud- River ferry schedules. They're tak- refuge in the pale stone- and-glass -rises that blossomed on the New ey side of the river in the late '90s.

Jersey City officials are hoping igh of the newest arrivals stick nd long enough to give it the critical ; it has long sought to become a fi- ial-center player.

ithin two weeks of September 11, 'the largest 18 firms from the World e Center moved at least some of e operations west. Among the ars were such heavy hitters as nan Brothers, American Express, sche Bank, and Merrill Lynch. All the Manhattan refugees gobbled up 1 million square feet.

or some of the dispossessed, it was ly the easiest move—they could dy pack employees into buildings already leased or owned. But even others, Jersey City had plenty to ; starting with a 6% vacancy rate ommercial space. Deutsche Bank, xample, had recently rented offices a troubled dot-com.

hy all the empty space? Jersey City

has been trying to lure Manhattan com- panies to its side of the river since 1996. But commercial building on the water- front didn't start in earnest until 1998 when the city broke ground for an office tower quickly leased to U.S. Trust, Cigna, and UBS/Paine Webber. With the continued boom on Wall Street, five more towers went up by 2001.

Jersey City Mayor Glenn Cunning- ham says the city isn't actively recruit- ing companies to cross the Hudson, as that would be inappropriate. "Jersey City prospers as New York City pros- pers," Cunningham says. "We want to see them rebound." Still, Jersey City is set to roll out a tax plan that would give a break to waterfront developers who also invest downtown.

BETTER WIRING. But for now, most Man- hattan refugees are heading for the wa- terfront. There, tenants are finding bigger offices better wired for high-tech equip- ment than many available midtown Man- hattan locations. "New Jersey built build- ings that you just can't get in New York City," says Don Eisen, managing director at realtor Cushman Wakefield.

Things are also cheaper. Companies generally pay 50% to 70% of Manhattan prices when they set up shop in Jersey City for everything from rent to electricity. And taxes run about \$3 a square foot, vs. \$12 to \$14 in Manhattan.

The short distance from Wall Street has also been a big draw. Manhattan commuters can take a 10- minute ferry trip or a 30- minute ride on the PATH train, the century-old line that connects Manhattan to

New Jersey. That's **THE WATERFRONT:** much quicker than *Cheap costs are a commute out to the main draw* rival sites in White

Plains, N. Y., or Connecticut. Still, travel isn't trouble-free. Morgan Fisher, an in- ternal wholesaler at investment bank Lord, Abbett & Co., must now take four trains from the Upper East side to work. While the ferry is faster, she says, "that would be a \$13 commute each day."

The prospect of more arrivals has re- vived many projects that were sealed back early this year as the economy slowed. On a riverside lot, Goldman, Sachs & Co. is building the tallest struc- ture in New Jersey, a 40-story tower set to open in 2003. Merrill Lynch & Co. is reportedly planning a trading floor, while some renters like Deutsche Bank are said to be considering a permanent move. A total of 5.8 million square feet of office space is being built, with 14 million more planned, nearly twice the size of the Trade Center.

Indeed, there's little question that a boom has hit. At the Iron Monkey restaurant a block from the waterfront,

already brisk daytime busi- ness is up 20% since Sep- tember 11. Still, the host of shops, restaurants, and bars that Wall Streeters are used to remains far off. "There's not nothing, but there's close to nothing," ad- mits Dan Frohwirth, direc- tor of real estate for the Jersey City Economic De- velopment Council. To many a Wall Street refugee, though, that's plen- ty for now.

By Heather Timmons in Jersey City

BIG LITTLE CITY Jersey City Growth

	MILLIONS OF SQUARE FEET
EXISTING	9.4
UNDER CONSTRUCTION	5.8
ON THE DRAWING BOARD	14.3
TOTAL BY 2005	29.5

Data: Jersey City Economic Development Corp.

EDITED BY JOHN PROTOS

AT ENRON, THAT RUN-DOWN FEELING

THE GOOD TIMES ARE LOOKING even farther away for Enron. The company's inability to extend its energy-trading model to some other commodities is proving increasingly costly. On Oct. 16, the nation's top natural-gas trader and leading wholesale electricity marketer reported a \$1.01 billion charge. Among other things, that covers recent forays into broadband and water trading—as well as the unraveling of a pair of limited partnerships. Those partnerships had raised questions about conflicts of interest. Until recently, they had been overseen by the company's CFO, Andrew Fastow, even though they were outside entities that bought assets from Enron. The aftertax charge was one reason the company posted a \$618 million loss in the third quarter, vs. a profit of \$292 million in the year-ago period.

CLOSING BELL

TASTY CHIPS

Gamers aren't the only ones happy with graphics chip-maker Nvidia. The Santa Clara (Calif.) company's stock has nearly doubled since Oct. 1, to \$41.70 on Oct. 17. Investors bet earnings will get a boost from new chips for desktops and software for notebook PCs, as well as a deal to supply key components for Microsoft's upcoming Xbox game console.



Without the charge, Enron would have shown a profit of \$393 million for the quarter.

DEEPER CUTS TO KEEP UNITED ALOFT

A WEEK AFTER THE SEPTEMBER 11 terrorist attacks, United Airlines slashed its flight schedule to reflect the falloff in demand for travel. Turns out this wasn't enough. So on Oct. 15, the UAL subsidiary said that, starting Oct. 31, it would cut flights to 1,654 a day, nearly one-third below early September levels. Will that stem its slide? UAL is already expected to lose \$1.8 billion this year. And in a letter to employees, Chairman James Goodwin warned: "United will perish sometime next year," if the hemorrhaging doesn't stop.

MERRILL LYNCH HAS TO SLIM DOWN

ON OCT. 16, AMERICA'S LARGEST brokerage, Merrill Lynch, said it may lay off 10,000 of its 68,200 employees. The move is part of a broader shakeup being carried out by new President Stanley O'Neal—under pressure from the board, say analysts, to improve the firm's performance. "[O'Neal] is going to achieve the restructuring and the cost improvement that the board wants," says Guy Moszkowski, a securities industry analyst at Salomon Smith Barney. O'Neal may have little choice. Many on Wall Street believe the firm could ultimately be forced to sell out otherwise. But a successful restructuring will diminish that likelihood.

THE STATES GANG UP TO BUY DRUGS

SIX STATES ANNOUNCED A PLAN on Oct. 17 to buy drugs collectively in an effort to curb

HEADLINER: STEVEN BRILL

CONTENT-FREE

STEVEN BRILL, SELF-anointed media critic and the founder of *American Lawyer* magazine, has always seemed to be more journalist than businessman.

That became all too clear on Oct. 15, when Brill, 51, announced that he was folding media watchdog magazine *Brill's Content* and selling his remaining stake in the Inside.com media site to co-owner Primedia. Neither had ever turned a profit.

The move also marked the end of Brill's controversial partnership with Primedia. Earlier this year, Primedia had taken a 49% stake in Brill's company, as

the two tried to meld their media properties. But a clear business strategy for combining those assets was never articulated and relations between Brill and Primedia CEO Thomas Rogers had become strained.

Brill had made a name for himself in the 1980s with the highly successful launch of *American Lawyer*. Then in 1991, he went on to found *Court tv*. But reinventing himself as a media scrutinizer proved too much. So for now, Brill will have to content himself teaching journalism classes at his alma mater, Yale University.

Tom Lowr

escalating prescription drug costs. Working together, the states of Maryland, Mississippi, Missouri, North Carolina, South Carolina, and Washington will use their combined buying clout to win volume rebates from pharmaceutical companies. For now, they represent some 1.2 million current state workers and retirees. That number could grow if other states—even private employers—join the group. And at the same time, eight Northeastern states are now discussing forming a similar pool.

A BLEAK WINTER FOR BETHLEHEM

AFTER 97 YEARS IN BUSINESS, once-mighty Bethlehem Steel declared Chapter 11 bankruptcy on Oct. 15. The company was done in by cheap imports, anemic demand, and a \$3 billion tab for health-care liabilities it owes retirees

and their families. Bankruptcy may enable the nation's No. 3 steelmaker to limp along until it can find a buyer for its state-of-the-art mill. Suits, though, are likely to be scarce, considering that Bethlehem's filing could put even more steel companies into insolvency. Industry observers say the company's almost certainly cut prices to maintain cash flow. Next, warn analysts, could be Western Steel or Birmingham Steel, because of their heavy debt loads.

ET CETERA...

- AT&T and British Telecom communications will end their Concert joint-venture.
- S&P cut GM's and Ford's long-term credit rating two notches, to BBB+.
- Bristol-Myers Squibb won an appeal to keep generic drugmakers from making BuSpar anti-anxiety drug.

GOOD NEWS

YOU'RE AN IDEA GUY.

BAD NEWS

YOU'RE AN IDEA GUY.



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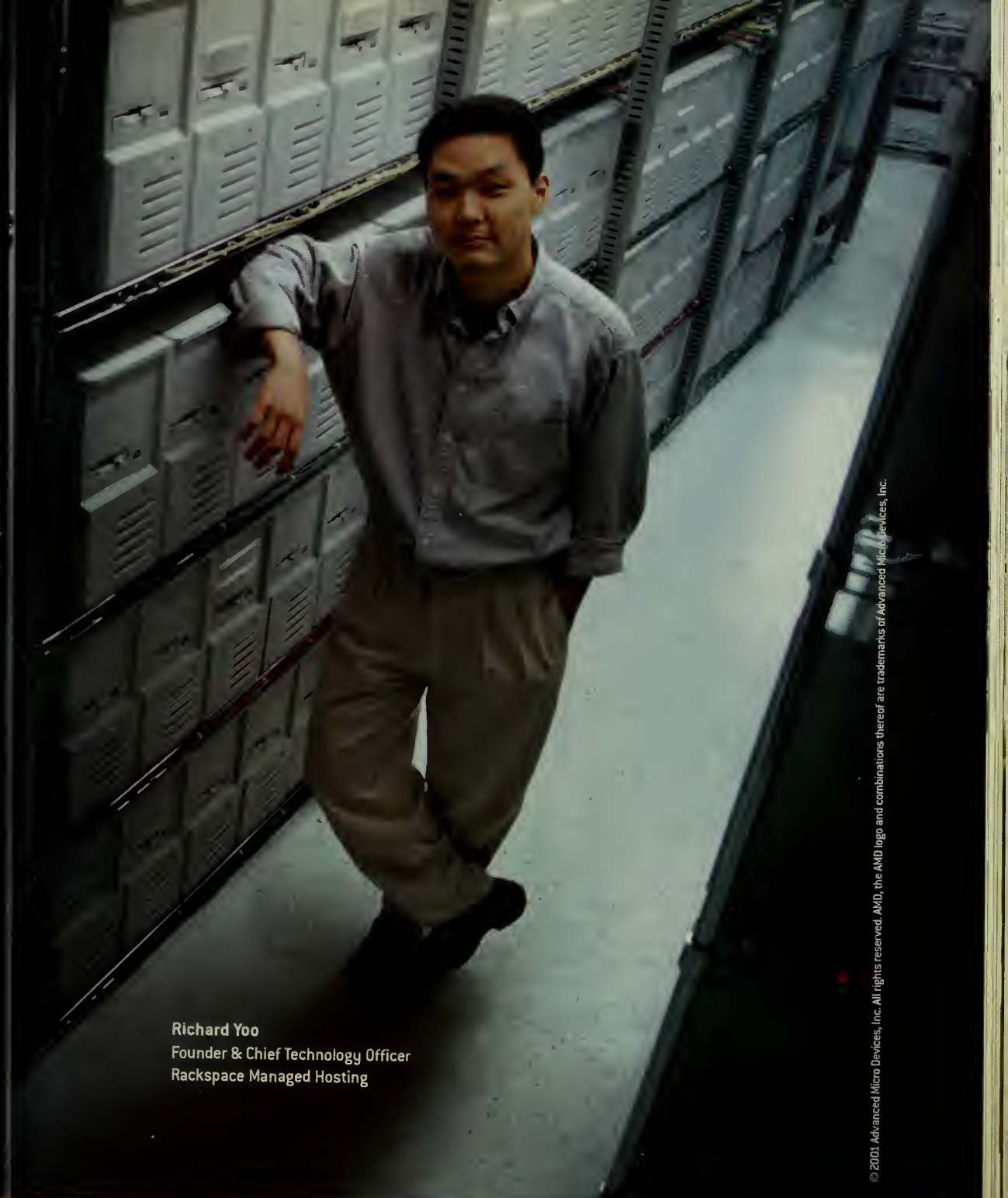
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A man, Richard Yoo, is standing in a server room. He is leaning against a rack of server units on his left. He is wearing a light-colored button-down shirt and khaki pants. The server racks are filled with various electronic components and cables. The room has a clean, industrial look with a light-colored floor.

Richard Yoo
Founder & Chief Technology Officer
Rackspace Managed Hosting

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RICHARD S. DUNHAM AND LORRAINE WOELLERT

DEMOCRATS: THE HAWKS ARE BACK IN TOWN

At 8:30 a.m. on September 11, Representative Norman D. Dicks (D-Wash.) was repeating his usual pitch to House Democratic leaders about the need to boost defense spending. "I was getting a lot of yawns until someone walked in and they had just hit the towers," Dicks says. "I don't think you're yawning anymore."

No, indeed. The Democrats' resistance to a massive infusion of spending for defense modernization ended that day. The attacks jolted the party out of its post-cold war emphasis on economics and domestic policy and gave rise to a new breed of hawk. The Demo-hawks—more a subset than a wing of the party—are trying to develop a pro-defense, internationalist agenda. It has been seen since the days of Washington Senator Henry "Scoop" Jackson. Among them are: Senator Joseph I. Lieberman (Conn.); Senate Foreign Relations Committee Chairman Joseph R. Biden (Del.); Representative Jane Harman (Calif.); top Democrat on the House panel responsible for homeland security; and Dicks, a longtime Pentagon champion.

LICLOSE. The most outspoken is Lieberman, who sounds far more bellicose than President Bush. In an Oct. 15 speech to the New Democrat Network, he said the U.S. should be "unchanging in our determination" to remove Iraqi leader Saddam Hussein. He warned Syria and others that they would share the Taliban's fate unless they ended support for terrorists. Indeed, Demo-hawks have outflanked their party leadership—including former Vice President Al Gore, Senate Majority Leader Tom Daschle, and House Minority Leader Richard A. Gephardt—which stands solidly with Bush.

That's a big change in a short time. With the end of the cold war and the loss of pro-military Democrats such as Senators Tim Wirth of Colorado, Tim Wicker of Nebraska, Sam Nunn of Georgia, and Charles Robb of Virginia, the party had precious few figures willing to

make the case for costly new weapons systems. "You essentially have a generation of lawmakers who don't have a lot of experience in foreign policy," concedes Simon Rosenberg, president of the New Democrat Network.

The party's lack of emphasis on defense didn't matter much when peace and prosperity reigned. But now Dems find themselves scrambling on the new No. 1 issue. "The Republican Party historically has had a solid advantage on national security," says Will Marshall, president of the Progressive Policy Institute,

a centrist Democratic think tank. "That's a political liability the Democrats need to squarely address." Adds pro-military Senator Robert G. Torricelli (D-N.J.): "Vietnam was such a point of reference for Democrats for so long that it blinded [them to] any other historical experience."

What's next as the hawks try to harken back to the firm foreign policy of Harry S. Truman and John F. Kennedy? Lieberman and Biden—both potential 2004 Presidential candidates—may try to out-tough the President by condemning rogue nations that resist U.S. attempts to extirpate terrorist cells. Indeed, jockeying for the 2004 nomination has been turned upside down as military vets rise to the top and others with scant foreign policy credentials, such as North Carolina Senator John Edwards, slip a rung. "It's going to put a premium on people with an intellectual capacity to sort out com-

plex international problems," says Kerrey, a decorated Vietnam War vet and president of the New School University in New York. Perhaps Kerrey himself?

The neohawks are still struggling with their agenda—and their identity. "The hawk-dove thing was overused in Vietnam," protests Dicks. "If I'm going to be a hawk, I want to be a *rational* hawk." Whatever they're called, the challenge is to convince skeptical Americans that the Democratic Party is not the party of the dove.



BIDEN: Looking to 2004?

CAPITAL WRAPUP

LEAD MY LIPS: NO NEW BAILOUTS

The beleaguered airline industry walked away with \$15 billion in federal aid, but the message for other industries is: Forget about it! Bush aides renewed the corporate beg-fest that followed September 11 as unseemly. Budget Director Mitch Daniels dashed lobbyists' hopes in a speech on Oct. 16: Other sector-specific bailouts should be avoided.... Attempting to rush other sector to sector applying first aid could be an economically futile and fiscally ruinous mistake," he said.

TELECOM GOODY?

► Telecom lobbyists are struggling to get back on the agenda in the wake of the terror attacks. Industry leaders such as Lucent Technologies and Cisco Systems—already suffering from the dot-com shakeout and a slowing economy—want Congress to include in any stimulus plan a \$2 billion tax credit for companies that roll out new high-capacity Internet lines. Plan B is to persuade President Bush to make a commitment to broadband in his January State of the Union address.

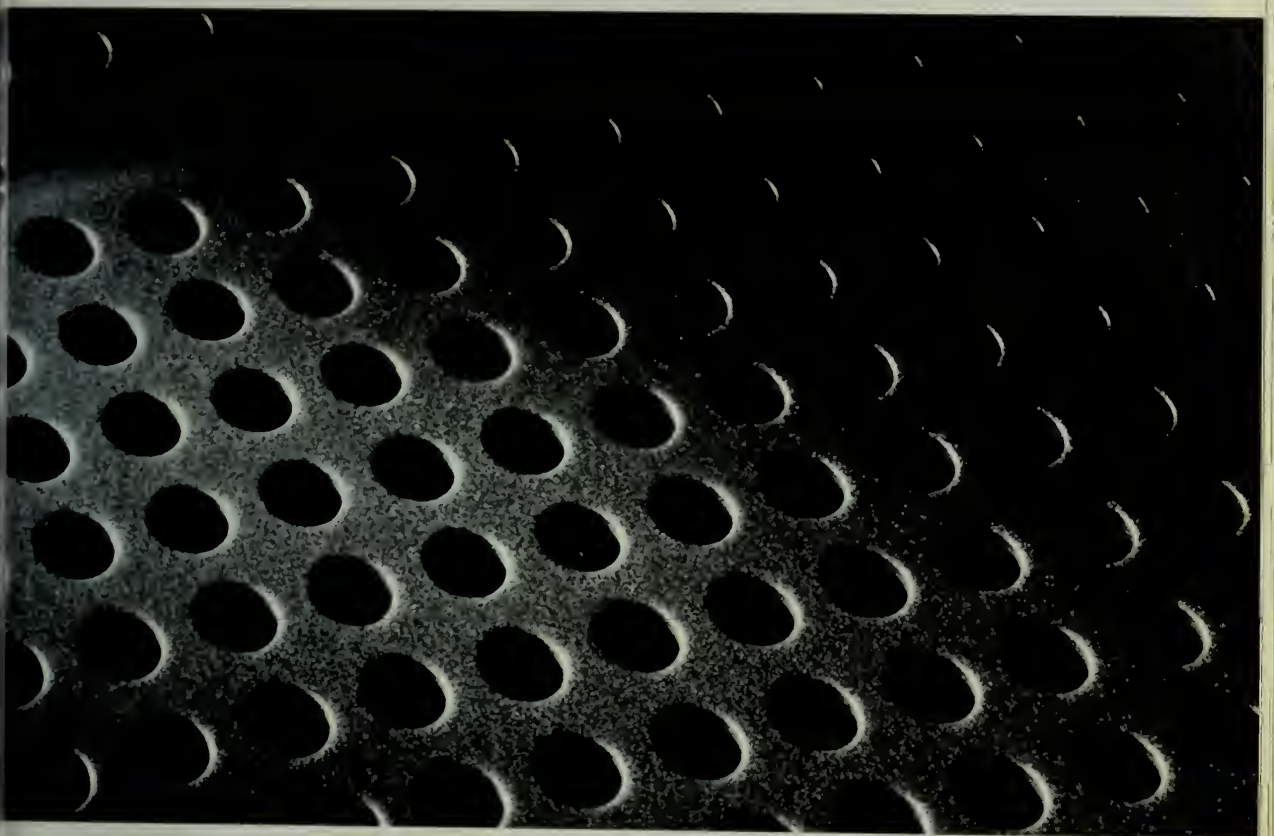
GOP TROUBLES IN JERSEY

► President Bush's record-breaking popularity isn't giving Republican gubernatorial candidates much of a boost in two Nov. 6 contests. In Virginia, Democrat Mark Warner clings to a narrow lead, despite the state's GOP tilt. And some New Jersey Republican veterans worry that nominee Bret Schundler's gaffe-marred campaign might cost the party control of the governor's mansion and the legislature. Among his boo-boos: criticizing the state's response to September 11.

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ASIA'S FUTURE

CHINA



William Fung is a practical man. As group managing director at Hong Kong's Li & Fung Ltd., a giant Hong Kong trading company, his job is to find ways to produce and ship goods to global markets the fastest and cheapest way possible. So he already has a plan for China's imminent entry into the World Trade Organization, the global body that en-

forces free-trade rules. One of the trade barriers that Li expects to fall is U.S. and European import quotas on clothes made in China for children up to 2 years old. Most of the apparel Li & Fung trades in that category is now produced in Egypt, Thailand, Sri Lanka, Honduras, and Guatemala. Fung plans to shut operations in all those countries and move baby-clothes production to

southern China. Sure, the labor will be a bit more in China, "but the productivity!" he says. Moreover, transportation to the key U.S. market is fast: "Shipment time from China to California is 14 days, vs. 30 days from Sri Lanka."

The same kind of cold calculation under way inside corporations across the world. In their race to slash costs the global economy slows and pro-

unge, companies are looking anew for west-cost manufacturing centers. And for they do the math, the winner, very ten, is China. Even as the new war against terrorism is realigning the political world, China's arrival as a manufacturing superpower is reshaping world trade. Its advantages are formidable: abundant cheap labor, millions of talented engineers, good infrastructure. And thanks to the terms Beijing formally accepted on Sept. 11 in order to enter the WTO, at enormous market will eventually be thrown wide open to foreign competition. Multinationals in industries from semiconductors to Internet routers to passenger cars are increasingly beating a path to China's door.

There's a dark side to this story, though. For every gleaming factory on the China coast that's producing world-class goods, there's a rusting hulk of a state-owned enterprise that's barely holding on. While many Chinese are now joining the middle class, millions are slipping into a new underclass of displaced peasants, unemployed factory workers, and low-level laborers whose wages barely sustain them. Beijing has managed to keep the lid on these mounting social problems by pumping billions of dollars' worth of exports, which in turn have sustained government social spending and eased the painful transition to a market economy.

STOPPABLE FORCE. That balancing act is now going to get very hard. With U.S. raining bombs on Afghanistan, more uncertainty has been introduced to already shaky markets. "This war will have a major impact on the world economy," says Michelle Wang, a sales rep at an office-supplies shop in Beijing. "And because China is about to enter the WTO, China is becoming a part of the world. So it's clear we will be affected, too."

The short-term effect could be nasty indeed. Last year, China's exports grew 6%; this year, they will be flat. Slow-growth means China has fewer jobs than its growing legions of unemployed. China's executives and policymakers are aware of these risks. So are the multinationals involved in the mainland. But they are willing to make a big bet—bet Beijing, which has managed over years to transform its economy, can maintain enough stability to make their investments pay off. The new Chinese industrial machine "is an unstoppable force," says Michael E. Marks, CEO of contract-manufacturing giant Flextron Corp. in San Jose, Calif.

And it will affect every region of

the world. Flextronics is rapidly expanding its two sprawling manufacturing complexes in China, where it now makes cell phones and computer products. Within seven years, Mexico and the Caribbean will lose thousands of garment-industry jobs to China as the U.S. and Europe lift their last re-

Will its entry into the WTO unleash new prosperity or further destabilize the world economy?

straints on Chinese-made textile products. In Taiwan and Malaysia, two of the high-tech export hot spots of the 1990s, new investment in semiconductor, disk drive, and computer plants is drying up as companies such as Intel, Motorola, and Dell Computer move production to China. Matsushita, Sony, and Samsung are preparing a wholesale transfer of production facilities to the mainland. At a time when most emerging markets are desperate for outside capital, direct foreign investment in China was up 20.4%, year-on-year, for the first eight months of 2000, to \$27.4 billion. That's more than the rest of non-Japan Asia combined.

Beijing is holding a big bash to celebrate its entry into the WTO when it hosts the Asia-Pacific Economic Cooperation meeting in Shanghai from Oct. 15-21. A number of world leaders, including President George W. Bush, are scheduled to attend. Of course, the military action in Central Asia has taken some of the bloom off that occasion.

But even if the summit is low key, China's leaders are justified in raising a glass to their achievements. When China first launched its quest to join what is now the WTO back in 1986, it asked for special favors, citing its poverty and backwardness. Beijing demanded the right to control key industries tightly, limit foreign ownership of factories,

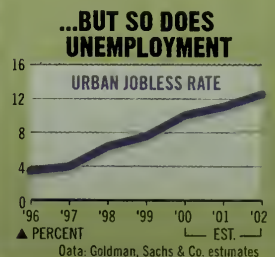
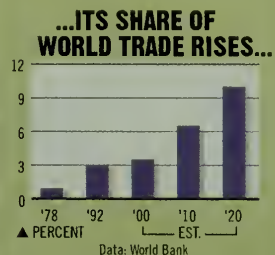
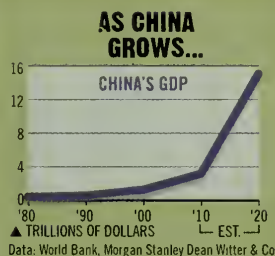
and protect access to telecom and financial services. U.S. and European negotiators wouldn't budge. A wise move: As time passed, President Jiang Zemin and Premier Zhu Rongji increasingly saw the market discipline required by WTO rules as an opportunity to force reform on industries and bureaucracies.

Jiang and Zhu hope the restructuring has prepared China for the time when it formally enters the WTO, which is likely to be in early 2002. At that point, new trading rules start to kick in. Over the next five years, China will eliminate all the quotas and other nontariff mechanisms that have kept out foreign goods. Duties, which have already dropped from an average of 44% in 1992 to 15% today, will fall to 9%. Foreign banks will have the right to open 100%-foreign-owned branches anywhere in China and take deposits from Chinese in local currency. "We will provide finance services to individuals for the first time and contribute to the creation of a consumer class," says Lionel Johnson, director of international government relations for Citigroup.

Foreign telecom operators will be able to freely own parts of Chinese networks. Multinationals will have the right

to set up their own distribution networks rather than work through Chinese corporate middlemen, as they must now. Foreign carmakers will make and sell whichever models they wish and set up nationwide dealerships and service networks. In telecom gear, computers, and semiconductors—sectors that Beijing tried to protect for decades—imports will be duty-free by 2005.

Part of the incentive for foreign investors is that after WTO rules kick in, they can operate in China with a greater measure of legal protection. Nobody expects China to develop institutions to enforce WTO rules overnight. Still, the arbitrary power that Communist Party cadres long wielded over foreign investors can be challenged. "The key thing is that the



International Business

rules will now be on paper," says Andy Xie, chief economist at Morgan Stanley & Co. in Hong Kong. "That will be the biggest shock."

Assuming Beijing lives up to its promises, the opportunities are tremendous. One study of the WTO deal, by U.S. Agriculture Dept. economist Zhi Wang, estimates that China will import some \$264 billion worth of capital-intensive manufacturing goods such as vehicles, machinery, and electronics over the next 10 years. Half of those goods will be exported from Western Europe, the U.S., and Japan. Exports from Hong Kong, Taiwan, Singapore, and South Korea will surge as well. Western farmers will win big. China's pledge to sharply limit import barriers on wheat, corn, rice, and other agricultural commodities could boost its food imports by \$73 billion over 10 years.

In information technology, China has already passed the U.S. as the world's biggest user of mobile phones. By 2005, the number of cell-phone users in China is expected to more than double, to at least 260 million. In personal computers, China should pass Japan this year, with 10 million PCs sold. Jun Ma, a Deutsche Bank economist based in Hong Kong, predicts that a decade from now, the China effect will raise world economic growth by a quarter percentage point.

In China, Beijing is betting that the new boost from trade—and from more

dynamic domestic industries—will prolong the upward march in living standards. Although hundreds of millions of Chinese still live in poverty, economists say that about 100 million have now joined the middle class, which in China means earning at least \$2,500 a year.

You can see this affluence when you cross the border from Hong Kong. Mainland Chinese are now buying homes in leafy suburbs that are sprouting on the edges of coastal metropolises such as Guangzhou. To move to and from those cities, Chinese are traveling on new highways and will soon be riding on high-speed trains designed to reduce the country's fabled congestion. Chinese play golf at private clubs and educate their children at private schools. In glitzy Hong Kong-style shopping malls, consumers are buying up the latest in home appliances and IT gadgetry.

LOW-COST PRODUCER. What makes China such a formidable manufacturing center? It has an abundant pool of young, high school-educated workers earning about \$1.50 a day, with millions more entering the workforce each year. China's many universities and institutes are turning out well-trained yet relatively low-paid engineers. The cost of industrial land is among the cheapest in the world—about \$25 per square meter in Shanghai, half the price of that in Kuala Lumpur and Bangkok and 60 times cheaper than in Yokohama, Japan.

Phone service, ports, electrical power and other infrastructure in China's key coastal cities are among the best in the developing world. China's bureaucracy has become so streamlined that officials sometimes grant the necessary approvals for new factories in days.

In electronics, as recently as the mid-1990s, Chinese factories did little more than screw together radios, telephone handsets, and electronic toys from components shuttled in from Hong Kong, Taiwan, and Japan. Now foreign manufacturers are relocating semiconductor, high-end circuit-board and other sophisticated electronic plants to China. Intel Corp. operates a big memory-chip plant in Shanghai, and on Sept. 21 the company announced that it will spend \$300 million to double its size, mostly to serve the mobile phone industry. "China is already the No. 1 wireless market in the world," says Jason Chen, vice-president and general manager of Intel's China operation. "We have to be there to work with that industry."

China's success comes at the expense of workers and companies throughout the developing world that offer cheap labor but not much else. Even in India, which has some of the planet's lowest wages, low-tech industries can't compete with the Chinese in productivity. Shops in Bombay and Calcutta are flooded with Chinese goods. The Indian

THE GLOBAL IMPACT

China's entry into the WTO will affect trade everywhere

NORTH AMERICA

Farmers will get a new market for millions of tons of grain and rice. Semiconductor, telecom-gear, and computer makers will get duty-free access to China.

MEXICO

Garment and shoe industries will be hit hard as quotas limiting Chinese exports to the U.S. are lifted.

EUROPEAN UNION

Imports of Chinese shoes, dishes, and kitchen utensils will rise as the EU phases out quotas.

SOUTH KOREA

Exports of fabrics to China's surging apparel industry could swell, as could outflow of industrial gear and high-grade steel.

SOUTHEAST ASIA

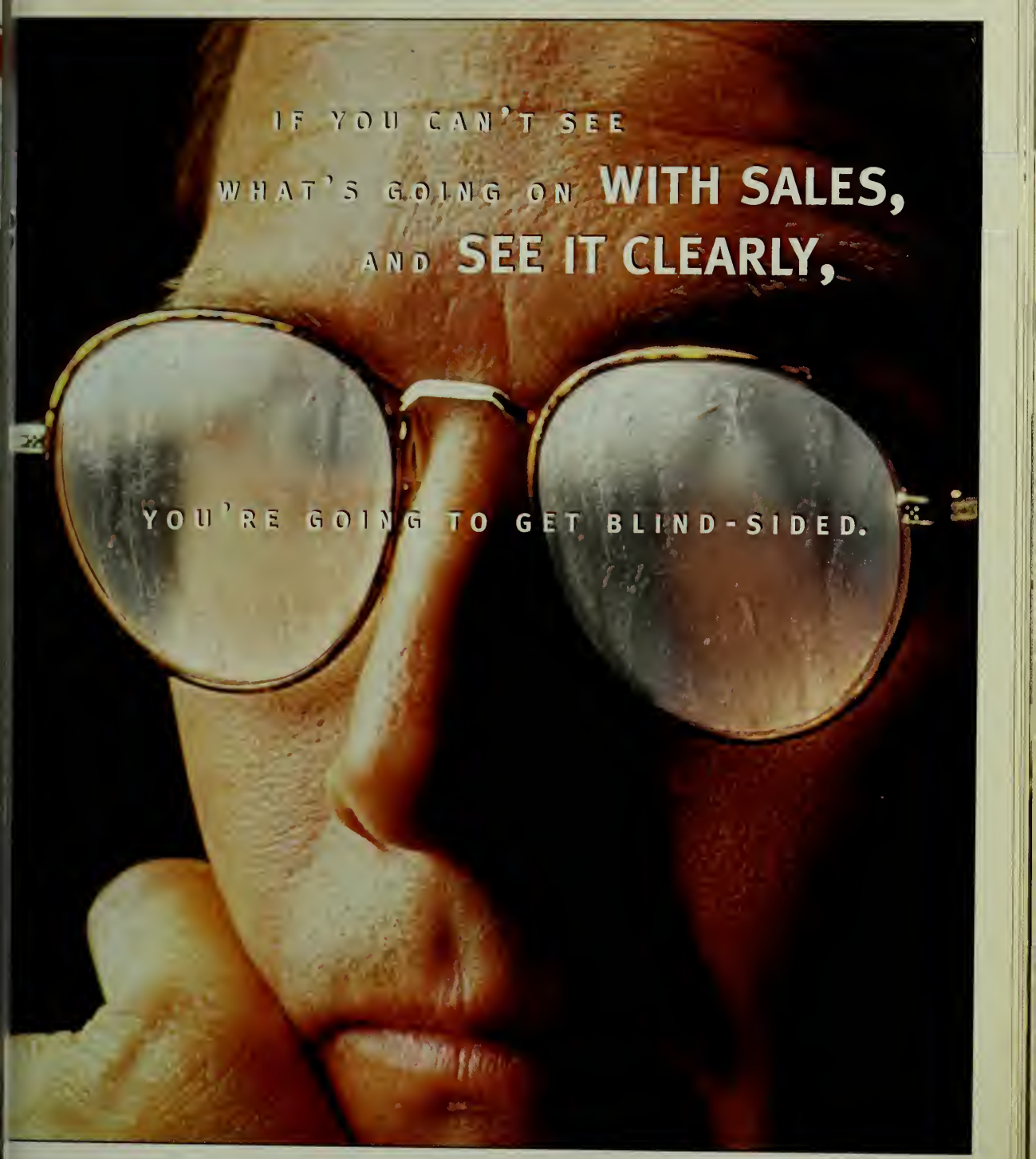
Thailand, the Philippines, Indonesia, and Malaysia will lose foreign investment to China. Pressure will grow to upgrade industries and workforces.

JAPAN

Imports of a wide array of consumer goods will grow as more Japanese manufacturers shift production to China-based suppliers. Equipment, vehicle, and electronics exports will rise.

TAIWAN

It joins the WTO so its \$16 billion trade surplus with China will fall. production will China, boosting competitiveness of wan tech comp



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government is so worried about China that it has refused to allow Chinese software companies to locate in the high-tech center of Bangalore and scotched plans by software powerhouse Infosys Technologies to train 200 Chinese employees in India.

Hardest hit is Southeast Asia. A decade ago, the Association of South-east Asian Nations took half of the foreign direct investment in non-Japan Asia, compared with just 20% for China. Now, those numbers are reversed. "Our products out of ASEAN will become less competitive because of the surge of made-in-China goods," says Yukio Shohoku, managing director in charge of global business for Japanese electronics giant Matsushita Electric Industrial Co.

Taiwan is both a victim and a long-term benefactor of China's rise. True, the mainland is sucking factory jobs out of its island rival by the thousands. But Taiwan will join the WTO at the same time China does, which means Taiwan's own restrictions on trade with the mainland will fall, too. "There are 50,000 Taiwanese-owned factories in mainland China screaming for banking services," says Jeffrey Koo Sr., chairman of Taipei-based Chinatrust Commercial Bank, which hopes to open its first office in China soon.

STRUGGLING FARMERS. China's WTO debut is not uniformly good news for the 1.3 billion Chinese. The threat of social instability is real. In the poverty-stricken countryside, the situation is only going to deteriorate after WTO entry triggers imports of cheap foreign grain. "Everybody is saying that the WTO is both a challenge and an opportunity for China," says Xia Ying, a research fellow at the China Academy of Agricultural Science in Beijing. "But for agriculture, the challenge is very real, and the opportunities are largely invisible."

Already, more than 100 million peasants have flocked to the cities in search of work, and that number is likely to increase, adding to China's angry underclass.

Frank Lu, director of the Hong Kong-based Information Center for Human Rights & Democracy, says that in 1999, the most recent year for which he has statistics, there were 100,000 demonstrations by workers and farmers protesting against low wages, unpaid pensions, and corruption.

As Beijing struggles with the social pressures aggravated by greater import competition, a big question is how faithfully policymakers will honor their WTO commitments. Old ways won't die quickly. Many foreign companies operating in China have long complained that locals enjoy unfair advantages thanks to their *guanxi*, or connections.

"They pay less tax, they get cheap electricity," gripes Sam Lo, the 39-year-old president of Hong Kong toymaker Tai Sun, which employs 2,000 workers in China. After WTO, Lo predicts that will be easier for Hong Kong companies to compete. "But still," he says, "I think our costs will be much higher."

One reason is that the Chinese government will still own a stake in many companies. Take TCL International Holdings, a Guangdong-based producer of televisions and other consumer electronics that had \$1.1 billion in sales last year. In late August, TCL said the first-half profits were off 31%. So even as he talks bravely about taking on

the competition overseas, Chairman Tomson Li expects a boost from the state, since a Guangdong municipality still owns a big stake in TCL. "We will continuously be supported by the Chinese government," says Li. While WTO entry should eliminate many barriers, "some things are visible, others are not," he says.

SKEPTICISM. Such resistance is inevitable, which is why many critics doubt whether Beijing has the wherewithal to push through the necessary changes. "There is a great deal of skepticism regarding China's willingness and ability to carry through on its commitments," says Fred Hu, chief economist at Goldman, Sachs & Co. in Hong Kong.

But there are also reasons to believe that China will honor its WTO membership more than it will abuse it. The Chinese have built up a solid track record of more than two decades of economic reform. And the long-term stability of the country depends on the growth that can come only when foreigners are convinced that China will play by global rules. The whole new world is opening, says William Fung of Li Fung. The world—and China—had better be ready.

By Bruce Einhorn
Hong Kong, with Ches Dawson and Irene M. Kuo in Tokyo, Dexter Roberts in Beijing, Alysha Webb in Shanghai, and Pete Engardio in New York

THE LONG MARCH



1972: Mao, Nixon

1972 U.S. President Richard Nixon visits Mao Zedong, setting the stage for normal diplomatic contacts.

1978 Two years after Mao's death, Deng Xiaoping rises to power and ushers in economic reforms.

1979 China emerges as a new low-wage manufacturing base for Hong Kong and other countries.

1982 Communes are dismantled in the countryside.

1985 Beijing slashes average tariffs from 56% to 43%, beginning a gradual reduction of import barriers.

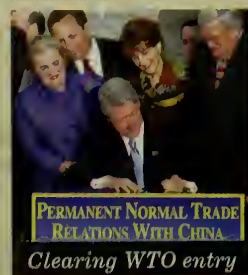
MID-1980s First foreign joint ventures begin production for the Chinese market.

1989 Bloody suppression of pro-democracy protests in Tiananmen Square freezes relations with the world. Foreign investment plunges, and market reforms are put on hold.

1992 Deng Xiaoping reignites economic reform, sparking new boom in exports and investment. State enterprises are given wider latitude to deal with foreigners.

1993 Shanghai Mayor Zhu Rongji, a favorite of foreign companies, becomes economic czar and starts urging faster reforms. He is now premier.

1997 Beijing leadership's 15th Party Congress opens the way for a sell-off of state enterprises and gives more rights to private entrepreneurs.



PERMANENT NORMAL TRADE RELATIONS WITH CHINA
Clearing WTO entry



Harvesting for export

1999 China and U.S. initial agreement spelling out terms for China's entry into the World Trade Organization. Beijing to dramatically lower barriers to foreign goods and services. U.S. agrees to halt annual reviews of China's trade status.

2001 On Sept. 17, last barriers fall to China's entry into WTO, likely to be finalized by yearend.

Data: BusinessWeek



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EDITED BY ROSE BRADY

BRITAIN: IS TONY BLAIR NEGLECTING THE HOME FRONT?

Never has a British Prime Minister been more popular. Tony Blair's tough response to the September 11 attacks in the U.S. and his diplomatic efforts to build an international coalition to fight terrorism have gone down well with the British electorate. An Oct. 12 poll conducted by the *Guardian* newspaper gave Blair an approval rating of 76%—on par with Winston Churchill's in World War II and higher than Margaret Thatcher's in the Falklands war.

Yet the ambitious PM may be in danger of spreading himself too thin. Since September 11, Blair has gaged in international diplomacy at a breakneck pace, jetting from London to Oman to Cairo and back to London to meet with Palestinian leader Yassir Arafat on Oct. 15. But even as Blair revels in his rising stature as a global statesman, severe problems are beckoning at home. In running for reelection to a second term last June, Blair staked his reputation on improving the country's education, health, and transportation systems, and securing a lasting peace in Northern Ireland. "Blair could face a backlash if domestic issues aren't addressed properly and quickly," warns Ruth Smeeth, a head of policy at the Institute of Directors, a business lobby. "He has gone out too far on one limb," adds the chairman of a leading British media company. "History has shown that there are often Prime Ministers and presidents who are successful abroad but disastrous at home." For now, no opposition politicians or rivals in his Labour Party are openly criticizing Blair. But business leaders and political analysts are getting worried that the PM simply won't have the time and resources to deal with a pressing domestic agenda as well as help rebuild Afghanistan, fight terrorism, push for peace in the Middle East. Test scores in Britain's national school system are plunging, and qualified teachers are fleeing. Meanwhile, the peace process in Northern Ireland is

collapsing as Unionist ministers threaten to resign over the Irish Republican Army's failure to disarm.

Perhaps most significant, the National Health Service remains underfunded and overburdened. A growing number of Britons are going to Europe for treatment rather than waiting months or years at home. Health spending is rising 6% a year. With the economy slowing—gross domestic product growth is expected to be 2.1% this year, vs. 2.9% in 2000—government revenues are on the decline. So maintaining health

spending is likely to require an unpopular tax increase, analysts say. In an Oct. 16 speech, Blair indicated tax hikes should be expected.

Meanwhile, the Labour government has not inspired confidence with the way it has handled another public service—the railways. On Oct. 7, the government suddenly pulled the plug on Railtrack PLC, the privatized owner of Britain's railway infrastructure, leaving the company's 250,000 shareholders out of pocket. That is raising questions about the viability of Blair's plans for public-private partnerships to fix other services like the London Underground.

As his stature rises on the international scene, Blair's smartest move would be to use his newly enhanced clout to make headway on domestic issues. The first sign he might try to do that came on Oct. 2, when he signaled for the first time his willingness to hold a referendum on Britain's joining Europe's single currency if the country is ready economically. The trouble is that 61% of British voters still oppose using the euro, and persuading them to change their minds won't be easy.

So Blair would do better to work on the tougher nitty-gritty issues, such as public services, first. When the shooting stops, he'll still have to run Britain. And its problems are mounting every day.

By Kerry Capell in London



THE PM: Soaring popularity

GLOBAL WRAPUP

BLOW TO THE COALITION?

The assassination of Israeli Tourism Minister Rehavam Ze'evi on Oct. 17 is the latest indication of how difficult it is going to be for the Bush Administration to hold together its international coalition to fight terrorism. The U.S. had hoped to reduce Israeli-Palestinian violence and even restart peace talks between the two sides. But with passions running high, gunmen from the Popular Front for the Liberation of Palestine (PFLP) shot and killed the minister in revenge for the Israeli

killing of PFLP leader Abu Ali Mustafa.

Israeli Prime Minister Ariel Sharon, who blamed Palestinian leader Yassir Arafat for the killing and called it the beginning of a "new era," is unlikely to refrain from harsh retaliation. Ironically, Ze'evi, a hardliner, was in the process of leaving Sharon's government to protest its being too soft on the Palestinians.

Israel and the Palestinians aren't the only regional players who will be tough to keep in line. Egypt has been warning the U.S. not to widen the campaign to Iraq or other Arab coun-

tries. Saudi Arabia is uncomfortable about the U.S. bombing of a Muslim country, Afghanistan, and has offered the U.S. only limited cooperation.

Now, a major escalation in Israeli-Palestinian violence will add tremendously to the tension. Mideast peace seems further away than ever.

By Stanley Reed in Cairo

BusinessWeek online

For more international coverage of the crisis, go to the Oct. 29 issue online at www.businessweek.com.

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EDUCATION

SCHOOL REFORM FACES AN INCOMPLETE

Education initiatives feel the pinch of the war on terror

Education Secretary Rod Paige was the key attraction at the heavily guarded gathering of governors and CEOs attending the annual National Education Summit on Oct. 9. His usual pitch for school reform was overshadowed by the motivators he and other speakers offered to New York City educators who had recently led thousands of schoolchildren to safety after the attack on the Twin Towers.

It was a stark reminder of how the nation's priorities had shifted. Prior to that terrible Tuesday, President George W. Bush and state governors had education at the top of the nation's to-do list. But now schools have taken a backseat to the war on terrorism and the sudden slowdown of the U.S. economy.

SHOWS. The summit showed just how much school reform has lost the spotlight. Planned as a star-studded celebration of a new era of reform, it ended up all but ignored as the crisis took away luminaries such as Bush, his brother, Florida Governor Jeb Bush, and California Governor Gray Davis.

More damaging are the harsh new constraints on spending as more states face mounting budget crises. After years of pursuing ambitious reforms, from higher standards to more equality of funding between rich and poor districts. But as money dries up, "things won't move as quickly," warns Jack Jennings, head of the Center on Education Policy.

Even before September 11, school spending had slowed sharply in many states. Education outlays were budgeted to rise an average of 3.7% in the fiscal year that ends next June in most states, according to the National Conference of State Legislatures (NCSL). That's well below the recent rate (chart).



Some states have already had to make cuts. A looming budget shortfall forced Alabama to slice school spending by 6.2% this year. Minnesota has whacked everything from teaching positions to busing.

Many more states will encounter similar pain in light of the economic slowdown. Ohio Superintendent Susan T. Zelman says she "will probably have to take a 6% cut" in her department's budget. On Oct. 11, Iowa Governor Thomas J. Vilsack ordered an across-the-board spending cut of 4.3%, though he will ask the legislature to "restore as much fund-

IN NEW YORK

The costs of September 11 could inflict lasting damage on city schools

ing as possible" to schools. Warns Kentucky Governor Paul E. Patton: "It will be a real challenge" to keep education funding at current levels next year.

Innovative reforms are often first to go. In Iowa, for example, the nation's most ambitious effort to tie teacher pay more closely to their skills "won't be scaled up as quickly as we would like," says Ted Stilwell, director of the state's education department. Reform has been stopped cold in Tennessee, where the legislature rejected all new initiatives because money was so tight.

Nowhere is the pain more acute than in New York. Even before September 11, the legislature had approved a bare-bones hike in the school operating budget. But with estimates that the attacks could cost the state and city budgets more than \$10 billion, schools may suffer lasting damage. In New York City, "further cuts could provide an impetus for people to leave the city," warns American Federation of Teachers President Sandra Feldman.

Many state officials also worry that the President's education bill could impose expensive

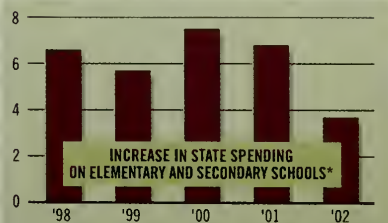
new burdens on them. The plan to test students in grades 3 to 8 could cost states more than \$1 billion in the first three years, figures the NCSL. "Our honest opinion [is] that this 'reform' [could] stop us in our tracks and send us off on a new and not necessarily successful course," the NCSL wrote in a Sept. 26 letter to Congress.

To be sure, there's still support for school reform. Congress is expected to pass most of Bush's education bill by Thanksgiving, probably with an extra \$4 billion or so in federal education spending. But that won't solve the funding crunch, since the feds provide just 7% of the nation's school budget.

The upshot is that education reform may be nearing a crossroads. During the boom years, fixing public schools seemed like a relatively painless crusade. Now, states face excruciating tradeoffs between expensive reforms and shrinking revenues. Scaling back may seem prudent now, but the long-term cost could be high.

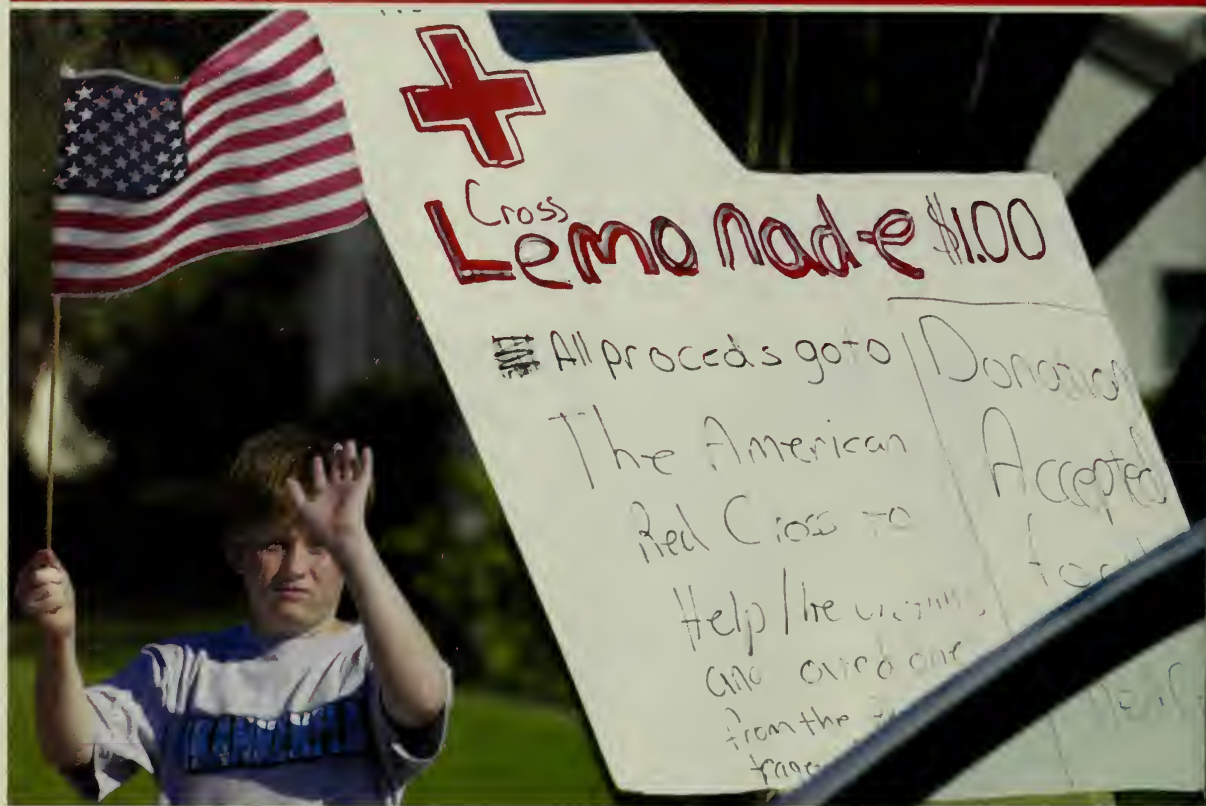
By William C. Symonds in Boston

SCHOOL BUDGETS WERE SLOWING EVEN BEFORE THE ATTACKS



▲ PERCENT *Data is for state fiscal years, most of which begin on July 1 and end on June 30. Fiscal 2002 began July 1, 2001.

Data: National Conference on State Legislatures.



GIVING

TOO BIG A HELPING HAND?

Money is gushing in, overwhelming September 11 charities

In the history of charitable giving there has never been anything like this. Since September 11 when hijacked passenger jets slammed into the World Trade towers, the Pentagon, and a field in rural Pennsylvania, outraged citizens from around the world have deluged relief organizations with donations that now approach \$1 billion. By way of comparison, contributions totaled \$45 million in the wake of the Oklahoma City bombing. Hurricane Andrew attracted \$110 million for the American Red Cross, the major charity. "It's multiples of anything that has been dealt with before," says New York Attorney General Eliot Spitzer.

Of course so is the need. The numbers of people affected are staggering:

5,000 dead, 7,000 children who lost a parent, 50,000 newly unemployed. But disbursing \$1 billion in a responsible manner is a complex proposition. Is all of the money going where donors intended? Is it being well-spent? *BusinessWeek*, in collaboration with ABC's *PrimeTime Thursday*, found:

- Top charities are recognizing that they've received more money than they can spend on direct aid to victims. For the Red Cross, the excess may be 50% of what they've collected.

- Five weeks after the attack there is still no mechanism to keep the more than 200 charities involved from making duplicate payments to one recipient or letting others fall through the cracks. Only about 10% of the money raised

has been distributed so far.

- Although the pressure to write checks is intense, defining need is surprisingly difficult. The scope is expanding beyond what anyone initially imagined. Some charities are stretching the definition of need to include the psychological damage from bioterrorism threats.

- Charities not directly linked September 11 are reporting declining donations even as demand for help increases because of recession.

Even for charities that have been around for decades, this tragedy changed all the rules. "Things have happened in reverse," says Daniel Bochoff, president of the American Institute of Philanthropy and Charitywatch.org. "Usually charities a need, put together a plan, then raise money. Here, the money came in so fast the charities are struggling to see what to do with it."

One thing is clear: not all the money will end up in the hands of the victims we've seen fleeing burning buildings on TV. The American Red Cross has raised some \$452 million and counting. Many TV stations continue to air public ser-

YOUNG DONOR
The Red Cross is spending \$2.5 million a day

ouncements offering an number for donors. The organization expects to distribute only \$10 million to help at the site and in grants to families. Currently, Red Cross is spending \$2.5 million a month on everything from counseling to serving hot meals and running respite centers for workers at Ground Zero. It plans to find the balance to help the organization prepare for other disasters in the wake of terrorists. That includes \$50 million for a national blood bank. Red Cross says that it has made it clear in the requests for assistance on its website and in interviews. "Light donors feel better to learn that their money may be sent far from the crash sites? No," says Red Cross President Nadine Healy. "We have been so straightforward in saying what we are using the money for," she says. "The disaster relief involves this entire country, and its readiness for future terrorist events, healing, for grieving."

The managers of the New York Times Neediest fund have a similar dilemma. For all of last year, the fund raised \$8 million; it has raised \$36 million for its Sept. 11 fund. Fund director Jack Rosenthal says not all of the donations will be needed immediately by the charities the fund has sent to distribute its cash. "I doubt all 10 agencies will be able to put out

Top 10 Charity Funds

Almost \$1 billion has been raised since September 11. As of Oct. 17, these are the biggest funds:

ORGANIZATION	AMOUNT RAISED MILLIONS	AMOUNT DISBURSED MILLIONS	TARGET
AMERICAN RED CROSS	\$452	\$109	Basic needs of victims and related long-term programs
SEPTEMBER 11TH FUND*	320	16	For the needs of victims, families, and neighborhoods affected
TWIN TOWERS FUND	50.3	0	Assists families of uniformed and other government personnel killed or injured
NEW YORK TIMES 9/11 NEEDIEST	36	2.7	Assists affected individuals and communities
SALVATION ARMY	35	not yet tallied	Immediate needs of affected people not helped by others
FAMILIES FOR FREEDOM	25.5	0**	Scholarship fund for children of victims
NYC FIREFIGHTERS 9-11 DISASTER RELIEF FUND	25	6.9	Aid for families of 344 missing and killed firefighters
NY STATE WORLD TRADE CENTER RELIEF FUND	20.5	0***	All victims and their families/dependents
ROBIN HOOD RELIEF FUND	16.8	2	Support for low-income victims and their families
WORLD VISION & CONCERTS OF PRAYER (NY)	8.4	0.75	For emergency, long-term, and unmet needs, provided by faith-based groups

*Includes the Tribute to Heroes Telethon

*** No mechanism yet for disbursement

**Disbursement starting Jan. 2, 2002

Data: Journal of Philanthropy, BusinessWeek

\$36 million...victim by victim," he says. So he's putting aside money to distribute in the future for three broad causes: saving jobs, education, and trauma counseling.

But Red Cross and the Times are just two of more than 200 charities involved. That raises its own set of problems. Attempts to coordinate giving among the

charities have met resistance. Attorney General Spitzer, who regulates charities in the state, hopes over the next few weeks to create a database that tracks grants. The goal, Spitzer says, is to identify people who may be falling through the cracks or trying to double-dip. Modeled on a similar database compiled after the Oklahoma City bombing, his staff is now pressing charities to provide their data.

GREAT DISPARITY. It seems an obvious move, but Red Cross refuses to provide personal information, arguing that it would violate privacy rights. Other critics wonder if such a system is feasible in a disaster this large. In Oklahoma City, where 168 people died and 853 were injured, roughly 45 charities were involved. Some estimate that as many as 200,000 people have been affected in this disaster, either directly by losing a relative, or indirectly by losing a job or housing.

Coordinating those 200 diverging agendas might be a first step toward solving the conundrum charities

now face: defining need. For starters there's great disparity in what survivors will receive from insurance, employers, and the government (table). On top of that, organizations like the Federal Emergency Management Agency are grappling for their proper role. Typically FEMA addresses natural disasters and funds the replacement of homes and property de-

What Can Victims' Families Expect?

NEW YORK POLICE OFFICER	PENTAGON EMPLOYEE (MILITARY)	WINDOWS ON THE WORLD KITCHEN WORKER	AIRLINE PASSENGER	KEEFE BRUYETTE & WOODS ANALYST
LIFE INSURANCE \$196,635 in city, federal, and union benefits; one year's salary; annuity (half of final salary); sick health insurance	LIFE INSURANCE Armed service members' group life insurance policy (up to \$250,000); plus family annuity of some portion of salary; death gratuity of \$6,000	LIFE INSURANCE Hotel & Restaurant Union Local 100 policy (\$15,000)	LIFE INSURANCE Depends on whether victims or their employers purchased a policy	LIFE INSURANCE Company policy worth up to \$200,000
CHARITABLE AND OTHER AID Police and Fire Widows' Children's Fund pays \$10,000; NYC Police Foundation Heroes Fund \$3,000 per family plus \$1,000 per child; others	CHARITABLE AND OTHER AID Army Emergency Relief, Navy-Marine Corps Relief Society cover immediate expenses, children's college tuition	CHARITABLE AND OTHER AID Crime Victims Board typically gives two weeks' salary, funeral expenses; Windows of Hope Relief Fund for restaurant workers' families; long-term help at Worker's Comp and Social Security	CHARITABLE AND OTHER AID Airlines to pay \$25,000 to each victim's family; along with all other victims, they are entitled to a still-undetermined sum from airline bailout fund	CHARITABLE AND OTHER AID Profit-sharing and bonuses to be determined at the end of the year. Until then, salaries are still being paid. KBW Family Fund also set up. Each family assigned a co-worker "shepherd" to answer questions

stroyed by hurricanes and earthquakes. Meanwhile, Congress is still considering whether to make new allocations, which could change victims' needs.

The most basic difference between September 11 and natural disasters is that this was a crime. And so the first question is whether victims deserve compensation regardless of need. Do shopkeepers whose businesses have dried up deserve relief funds? Should widows with sizable death benefits also be entitled to short-term relief? Should fire fighters' families receive extra money because of their heroism? Most charities are precluded by their charters and tax status from giving for any reason other than need.

Still, that leaves a big, big gray area. It helps explain why so far only a fraction of the money raised has made it out into the community. Besides, most charities are just beginning to figure out how much money will be needed to make up for whatever insurance and government payments don't cover, and what kinds of gaps they will be asked to fill. "Half of the needs we see today, I didn't see four weeks ago," says Lorie A. Slutsky, president of the 77-year-old New York Community Trust.

VAGUE GOALS. Of course, charities with the broadest mandates have the flexibility to meet unexpected needs as they arise. The Twin Towers Fund set up by the City of New York and to be chaired by Mayor Rudy Giuliani has deliberately kept its goals vague. Although primarily meant for the families of uniformed and government workers who died or were injured, administrator Tamara Lhota says it could end up funding education, counseling, housing, and legal services. "The goal is to meet needs as they become apparent," says Lhota.

Sometimes just reaching victims with clear needs is a problem. Red Cross has given out \$21.5 million in cash to victims' families for basics like rent and food. But it has much more to give and, despite the organization's calls to the families listed by employers and the city, many eligible for aid have not yet received it. Last weekend Red Cross took out full-page ads in newspapers asking people to call for assistance.

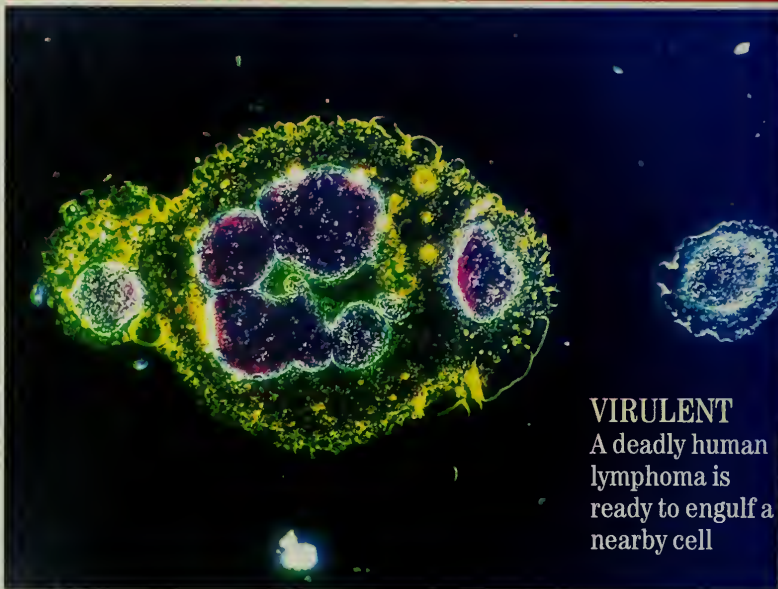
For charities trying to help people in downtown New York and across the country, the shockwaves of September 11 have only begun to be felt.

By Nanette Byrnes and David Henry with Brian Hundo and Susan Zegel in New York, Alexandra Starr in Washington, and bureau reports

BusinessWeek

For a related story on charities that have seen donations fall, go to the Oct. 29 issue online at www.businessweek.com

Science & Technology



VIRULENT
A deadly human lymphoma is ready to engulf a nearby cell

BIOTECHNOLOGY

FIGHTING CANCER—AND RIVALS

A patent battle could stall a promising breakthrough

On September 11, amid the horror of the terrorist attack on the World Trade Center and the Pentagon, little attention was paid to a medical breakthrough in Rockville, Md. A Food & Drug Administration advisory panel gave its wholehearted endorsement that day to a radically new cancer drug that sends a combination of radioactive isotopes and genetically engineered antibodies coursing through the blood.

Frightening as it may sound to some, the treatment, called radioimmunotherapy, appears to be remarkably safe. The antibodies target tumor cells only and then deliver their lethal payload, leaving healthy cells unharmed. It's not a cure, but the method has proven effective in slowing the progress of deadly non-Hodgkin's lymphoma. In clinical trials using the sickest patients—who usually have only a few weeks to live—radioimmunotherapy has caused partial or complete cancer regression for months at a time in as many as 80% of cases. Not a home run, but a notable base hit against a disease that almost always kills.

The FDA panel's unanimous recommendation of Zevalin, made by Immunomedics Inc. in San Diego, is an important milestone for radioimmunotherapy. The FDA almost always accepts panel recommendations and is widely expected to approve Zevalin in January. But the Sept. 11 decision set off a bitter patent dispute between Idec and its leading rival, Corixa Corp. of Seattle, with each company suing the other. Corixa, which completed filing for FDA approval of its radioimmunotherapy, Bexxar, on Sept. 7, argues that Zevalin violates a broad suite of patents. Corixa holds along with its marketing partner, GlaxoSmithKline PLC. Idec, which took legal action first, is seeking declaratory judgment that Zevalin does not infringe on anybody's patents. Patent disputes over drugs are common, but legal experts expressed surprise that one has gone so far. Most such battles are resolved by the parties long before court action is taken.

This time, though, the stakes may be too high for either company to

und without a fight. Because the two
gs are so similar, many analysts figure
t the one that reaches the market
t will dominate, bringing in first-year
es of \$50 million to \$70 million. That
ld go a long way toward justifying
ixa's \$900 million purchase a year ago
Coulter Pharmaceuticals Inc., primari-
o acquire Bexxar. Corixa CEO Steven
is says his company has patents devel-
back to 1993 that Coulter licensed
n the University of Michigan, where
drug was first developed. "Idec clear-
knew about the patents and listed
m in their 10-Q and 10-K reports [as
ential risks] but never contacted us,"
says.

Idec, with a reputation to defend as
antibody pioneer, retorts that Ze-
n is unique and covered by its own
ents. "We seek to show their
ents are invalid and we're not in-
gig," says Idec CEO William
stetter. Zevalin also represents a
nce for the company to strike out
its own. Idec won kudos for devel-
oping Rituxan, the first successful an-
dy-based cancer drug, but the lion's
re of the financial rewards have
e to marketing partner Genentech
t. That's no small loss considering
t Rituxan sales are expected to
ch \$875 million this year. With Ze-
n, Idec has retained all U.S. rights
reas rights were licensed to Scher-
AG). So while Corixa has said it
ld accept a licensing fee, Idec is in
mood to pay.

IDIOUS. Analysts worry that the
ent dispute may slow the marketing
both drugs as well as progress in
eloping radioimmunotherapies for
er cancers. "This isn't good for
ech," says Dr. Mark Monane, vice-
sident of biotechnology at market
archer Needham & Co. "We're hop-
the companies come to a reasonable
tion."

"The people with
most at stake
e are the pa-
nts. Non-
dgkin's lym-
ma afflicts more
50,000 people a
r in the U.S.
is the sixth-
ing cause of can-
death. It is an
idious cancer of
lymphatic sys-
t, which branch-
into all the or-
s. Because this
work is so vast,
disease can start
where in the
y and spread
ckly, sparking a

NUKING CANCER

*Two new drugs use antibodies to
deliver radiation directly to
the tumor cell.*

ZEVALIN

Combines antibody with yttrium-90
for treatment of non-Hodgkin's
lymphoma

MAKER: Idec Pharmaceuticals

STATUS: Recommended by FDA
advisory panel on Sept. 11

BEXXAR

Antibody combined with iodine-
131, also for non-Hodgkin's

MAKER: Corixa/GlaxoSmithKline

STATUS: Completed FDA applica-
tion filing on Sept. 7

wild proliferation of white blood cells
called B-lymphocytes that eventually
crowd out healthy cells. Survival rates
from the time of diagnosis range from a
high of 10 years to only six months.

Right now, the leading treatment for
non-Hodgkin's is Idec's Rituxan, an anti-
body that latches onto a bit of protein
known as the CD-20 antigen found only
on the surface of B-cells. There the drug
recruits the immune system to attack
the marauding cells. Radioimmunothera-
py adds a second line of offense by teth-
ering the antibody to a radioactive iso-
tope. Once the antibody attaches to the
cell, the radiation kills it off.

Both Zevalin and Bexxar target the
CD-20 antigen and both use similar an-
tibodies. The difference is in the iso-
tope: Zevalin is combined with yttrium-
90, while Bexxar contains iodine-131.
Some medical experts say yttrium may
have a slight advantage in that it ranges
over a larger area than iodine, which

may make it more effective against larg-
er tumors. That theory has yet to be
proven, however. Each isotope also has
a different safety profile: Critics worry
that Zevalin poses a slightly greater
risk to other organs over the long term
while Bexxar poses a greater risk to
caregivers because some of the radiation
leaks out of the body. But doctors be-
lieve that with careful monitoring, both
dangers are minimal.

COMPLETE RESPONSE. In fact, cancer
experts discount the competing argu-
ments made by Idec and Corixa. "There
is no major difference between the two
drugs. Both work well," says Dr. Louis
M. Weiner, chairman of the Oncology
Dept. at Fox Chase Cancer Center in
Philadelphia. He believes doctors will
be eager to try both. "My experience is
that if we have things that work, we
use them."

There's no question that the two
drugs work. In a clinical study reported
in the October issue of the *Journal of
Clinical Oncology*, Bexxar produced a
complete response in 20% of 60 ex-
tremely sick patients, and nine of those
had still not relapsed three years later.
Only 3% of patients receiving tradition-
al chemotherapy had a similar response.
Clinical trials of Zevalin, which is given
along with Rituxan, showed a complete
response in 30% of 143 very sick pa-
tients, compared with 16% of those given
Rituxan only.

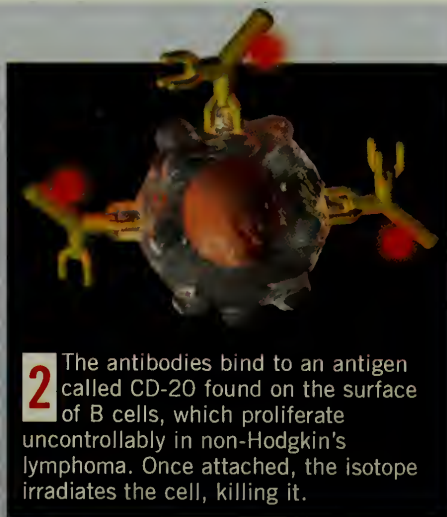
The Zevalin data clearly won over
the FDA panel. It not only voted to rec-
ommend the drug as a treatment for pa-
tients who fail to respond to Rituxan,
but the panel unexpectedly recommended
the drug for patients who fail standard
chemotherapy, provided the company
does more studies once the drug hits the
market.

Next up will be Bexxar, which is ex-
pected to receive its FDA panel hearing
in December. But
Zevalin is almost
certain to reach the
market first—and
Corixa CEO Gillis
says he won't try to
stop it. Instead,
says Gillis, Corixa
is seeking a perma-
nent injunction that
would remove Ze-
valin from the mar-
ket once the lawsuit
is resolved. Whoev-
er wins in court,
patients are bound
to come out on top.

*By Catherine
Arnst in New York,
with Arlene
Weintraub in Los
Angeles*

HOW THEY WORK

1 Genetically engineered
monoclonal antibodies,
all designed to attack
the same cellular target, are
tethered to a radioactive
isotope.



2 The antibodies bind to an antigen
called CD-20 found on the surface
of B cells, which proliferate
uncontrollably in non-Hodgkin's
lymphoma. Once attached, the isotope
irradiates the cell, killing it.



we generate promise.

We have all made promises. Spoken. Unspoken.

We may have stood over our sleeping children and said silently,
"I will give you better than I was given.

I will make a clean path to take you forward.

I will help make this world a better place."

At Duke Energy, we share this promise with others around the world.
We are 23,785 people with families, who love, live, raise children, and hope for the future.

And all of us have committed to be leaders —

creative thinkers, careful planners, and honest partners.

But, most of all, we have vowed to be true to our word and to ourselves —
to be keepers of promises.



we generate what's next™

Developments to Watch

EDITED BY CATHERINE ARNST

CHIP WIZARDRY: TRANSISTORS THAT BUILD THEMSELVES

ADDING COMPUTER CHIPS
laced with millions of transistors is a costly affair, with chip plants running upward of \$1 billion. That's one reason scientists at Lucent Technologies' Bell Labs are intent on inducing at least some of the elements on a chip to assemble themselves.

In the Oct. 18 issue of *Nature*, a Bell Labs team led by Hendrik Schon describes an important step in that direction. The team has created a transistor in which one of the key features is an atomic layer of organic molecules, called thiols. These define themselves with perfect precision on a gold-coated silicon substrate. No fancy photolithography is required, says John Rogers, Bell Labs' director of nanotechnology research, referring to today's standard circuit-printing technology. "The whole thing just happens in a beaker at a misty bench," he says, "and the device performs well as both an amplifier and an off switch."

Like all transistors, this device channels a current between two electrodes. In conventional transistors, these elements must be carefully designed and processed, with

AN ARTHRITIS DRUG RAISES THE RISK OF TB

TAKING REMICADE, A POPULAR DRUG FOR THE TREATMENT of rheumatoid arthritis and Crohn's disease, nearly quadruples the risk of developing tuberculosis, say researchers for the Food & Drug Administration. Their study, published in the Oct. 11 issue of *The New England Journal of Medicine*, found that from August, 1998, when the drug was approved, to May, 2000, 70 people treated with Remicade developed TB, and four of those patients died as a result. The annual incidence of TB cases in arthritis sufferers is normally 6.2 cases per 100,000, while for patients taking Remicade the rate was 24.4 per 100,000, the researchers said.

Some 170,000 people worldwide have received Remicade, made by Johnson & Johnson's Centocor unit, to control the pain associated with both arthritis and Crohn's, an intestinal disease. Centocor reported the high incidence of TB cases to the FDA this summer and, in August, changed Remicade's label to recommend that doctors test patients for TB infection before prescribing the drug. The company says its surveys show that 90% of doctors are now doing so.

Remicade is an antibody that suppresses tumor necrosis factor (TNF), a protein that plays a key role in inflammation. But TNF may also protect people who have been infected with the TB bacterium, says Dr. Joseph Keane of Boston University School of Medicine, the study's lead author. The World Health Organization estimates that one in three people worldwide harbors the bacterium, but only 10% ever develop the disease. Remicade may trigger these latent infections, Keane says. ■

special attention to shrinking the distance between the electrodes. At Bell Labs, that's not necessary. Instead, the distance is defined by the size of the minuscule thiol molecules—just one nanometer in length, or about the size of five carbon atoms in a row.

Hendrik Schon says it

could be 10 years before his new chemistry is adopted in commercial chipmaking. But other applications could come faster. The process may be ideal for manufacturing high-tech fabrics for wearable computers, and flexible computer displays that can be folded or rolled. *Neil Gross*

HELPING PEOPLE MAKE CONTACT IN A CRISIS

WHEN TERRORISTS STRUCK ON September 11, cell phones let desperate people exchange precious last words. But as callers crowded the airwaves, cell towers were swamped and connections were lost. A system called iCAR, for integrated cellular ad hoc relay, might help in such situations. It's a miniature base station, which might be no bigger than a headphone stereo, devised by University of Buffalo computer scientist Chunming Qiao and his colleagues. In emergencies, cellular service providers could slap iCAR devices on walls around the city. They would automatically pick up calls overflowing from congested cell towers and relay them to the nearest unburdened towers. Qiao's iCAR research was funded by the National Science Foundation and Finland's Nokia. So far, the phone giant has no plans to build the devices. *Neil Gross*

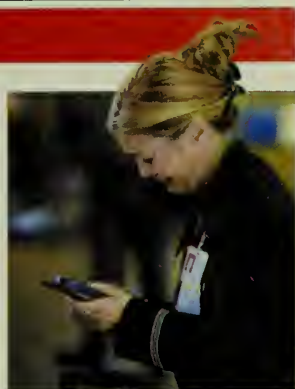
REDUCED SPERM SPEED STOPS PENETRATION OF THE EGG

THE LATEST EFFORT TO COME up with a male contraceptive focuses not on blocking or killing the sperm but on temporarily slowing it down. Researchers at the Howard Hughes Medical Institute and Harvard Medical School have discovered a protein found only in the tail of the sperm that plays a key role in powering it up to burst through to the center of the egg, where fertilization occurs.

The scientists believe that a drug aimed at temporarily blocking this protein could be taken by men or

women, before or even right after sex, with no lasting effect on fertility. The research is described in the Oct. 11 issue of *Nature*.

After discovering the protein, which they call CatSper, the scientists removed the gene that produces it from a strain of mice. The sperm of the altered mice were less vigorous than normal, and the mice were completely infertile. However, the researchers discovered that if they removed the outer coating of an egg, the weakened sperm could fertilize it normally. Howard Hughes researcher David Clapham says the protein may give the sperm's tail a turbocharge at the last minute to penetrate the egg. ■



Tough Times

He heads one of the most respected companies in the country, yet today, he works from a cramped and windowless office in Jersey City. But if Kenneth I. Chenault, CEO of American Express Co., notices the bland, standard-issue office furniture or tight quarters a world away from the spacious suite he once occupied in the American Express Tower in Lower Manhattan, he doesn't let on. With his company driven from its headquarters by the September 11 terrorist attack, Chenault does not yet know if he and the 3,000 AmEx employees who worked across the street from the World Trade Center will ever move back into the damaged building.

In the meantime, though, the dislocation and the rough-and-ready look of the hastily arranged new office are oddly appropriate for this moment in AmEx' 151-year history. If the old space spoke of permanence and stability, the new one suggests a willingness to dig into important issues in the midst of crisis, appearances be damned. As Chenault confronts an array of challenges that suddenly beset his company—not all of them the result of September 11—he will need exactly that kind of spirit.

Less than 10 months ago, on Jan. 1, Chenault got his dream job as CEO, one of the few African Americans to lead a major corporation. His arrival in the corner office came with extra-

How
Ken Chenault of
AmEx is being
tested in ways few
could have imagined

Cover Story

BY JOHN A. BYRNE
AND HEATHER TIMMONS

ordinarily high expectations. Like General Electric Co.'s Jeffrey R. Immelt, the 50-year-old Chenault was taken over a highly successful and transformed enterprise from an executive who wore very big shoes, the gruff and demanding Harvey Golub.

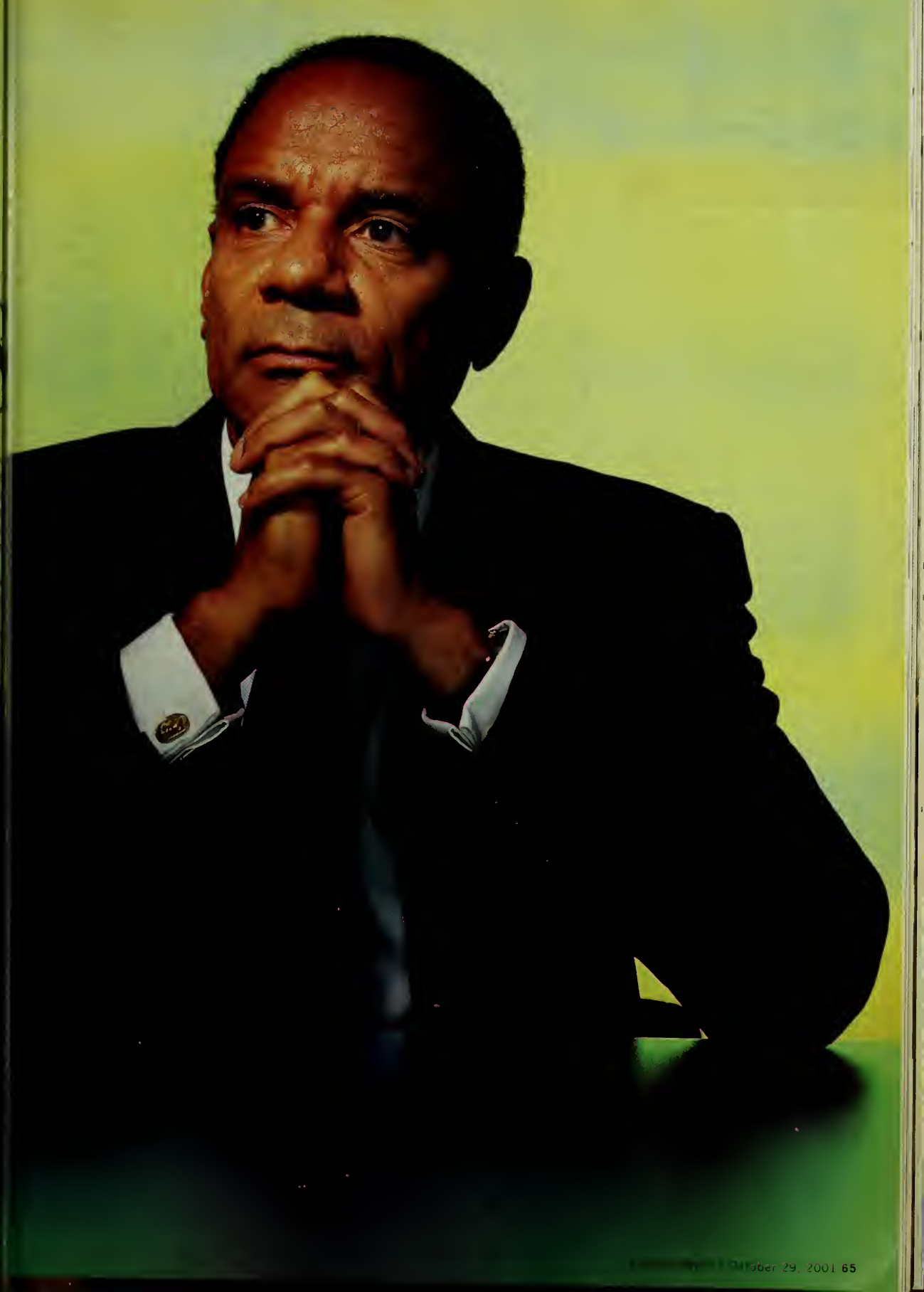
The meticulously planned transition had all the signs of a perfect handoff. With a smiling Golub by his side, chairman in January, Chenault proudly announced record earnings of \$2.8 billion on \$22.1 billion in revenues in 2000. But the good news was not to last. Just four months later, as Golub was giving up the chairmanship, Chenault shocked Wall Street with a \$182 million

write-off on some surprisingly risky high-yield junk bonds in its money-management operation in Minneapolis. The new CEO quickly reassured shareholders the worst was over. It wasn't: In July, he dropped a bigger bombshell, with an additional \$826 million charge on the same portfolio. The huge hit drove AmEx' second-quarter income down 76%, to \$178 million.

If Chenault stumbled in his first test as CEO by giving some the impression that he wasn't fully on top of the bond problem, he has surely shown the right leadership stuff

BRAD TRENT

For A New CEO





American Express stock is worth only half what it was

since the attack that cost the lives of 11 employees. Stuck in Salt Lake City on a business trip when the terrorists struck, Chenault took command long distance. When the first plane crashed, Chenault was on the phone with a New York colleague from his hotel room. He asked to be transferred to security and instructed them

Cover Story

to evacuate the building immediately. Edward P. Gilligan, who heads up the Global Corporate Services unit, recalls that when he made his way home to New Jersey on the afternoon of September 11, his wife handed him the phone as he walked through the door. It was Chenault, first to check on Gilligan's safety, second to convene a meeting of top execs. "He was there, and he was in the middle of it," says Gilligan.

The hundreds of ad hoc decisions made by Chenault and his team were guided by two overriding concerns: employee safety and customer service. AmEx helped 560,000 stranded cardholders get home, in some cases chartering airplanes and buses to ferry them across the country. It waived millions of dollars in delinquent fees on late-paying cardholders and increased credit limits to cash-starved clients.

HEARTFELT TALK. Most telling, Chenault gathered 5,000 American Express employees at the Paramount Theater in New York on Sept. 20 for a highly emotional "town hall meeting." During the session, Chenault demonstrated the poise, compassion, and decisiveness that vaulted him to the top. He told employees that he had been filled with such despair, sadness, and anger that he had seen a counselor. Twice, he rushed to spontaneously embrace grief-stricken employees. Chenault said he would donate \$1 million of the company's profits to the families of the AmEx victims. "I represent the best company and the best people in the world," he concluded. "In fact, you are my strength, and I love you."

It was a poignant and unscripted moment. Says AmEx board member Charlene Barshefsky, a partner at Wilmer Cutler & Pickering, who viewed a video of the event: "The manner in which he took command, the comfort and the direction he gave to what was obviously an audience in shock... was of a caliber one rarely sees."

In the aftermath of the crisis, Chenault, a native New

Yorker raised on Long Island, also has quietly emerged one of the most visible corporate leaders in America. When President Bush visited New York, Chenault was at his side stressing the need to improve security at the nation's airports and other public spaces. He stood with Mayor Rudolph Giuliani and Governor George Pataki when they asked for substantially more federal aid to rebuild New York. "Ken epitomizes two attributes I think will be important here," says Golub. "One is courage, and the other is composure."

Chenault, a Bowdoin College history major and Harvard Law School graduate, will certainly need plenty of both to guide his company through the coming months. As the world

When It Rains, It Pours

American Express has been on the receiving end of trends both of its own making and ones that weren't



AFTER SEPTEMBER 11
Everyone escaped the damaged offices, but 11 employees were killed in the neighboring towers



No.1 issuer of charge cards and the No.1 travel agent, American Express now finds itself at the center of a perfect economic storm. These core businesses, which account three of every four dollars of revenue, had already started slowing earlier in the year, along with the economy.

Then came September 11. Business and recreational travel has slowed to a crawl while the once unstoppable shopping U.S. consumer has now put away the plastic, further cutting into AmEx' revenues. Even the company's most valuable assets—its brand name and global scope—can be viewed

ear ago—and there may be worse to come

severe liabilities in the current climate when anything American can invite an irrational attack. "At the moment, all current events are weighing against the company," says Matt Edgar, co-portfolio manager of SISE Trust Fund in Walnut Creek, Calif., which owns 160,000 shares.

Investors have already felt the pinch. AmEx stock has fallen by half, to \$30 a share, in the last year, and there may be worse to come. As the economy plunges into recession, American Express is in many ways a far riskier company than it was in the last downturn, in the early '90s. It has more consumer debt, some of it of surprisingly poor quality. Its \$34 billion investment portfolio clearly carries

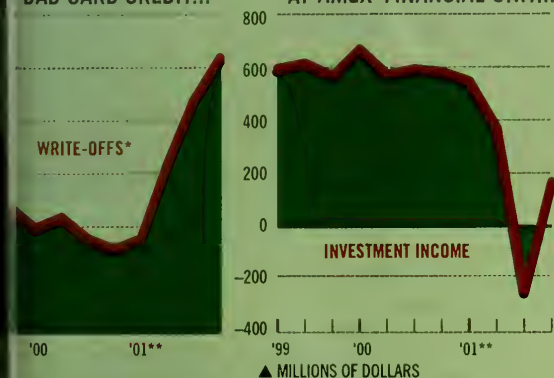
portedly expressed interest in a deal earlier this year, AmEx is now far more vulnerable to an unwanted takeover. Neither Morgan Stanley nor Citigroup would comment.

The stock could fall even further when Chenault reveals the company's third-quarter results on Oct. 22. He will unveil still more write-offs—some fully anticipated by Wall Street and some not. Analysts are braced for a charge of up to \$370 million for a restructuring announced last summer that could include as many as 5,000 layoffs. Some expect up to an additional \$200 million to temporarily relocate 5,000 employees to newly leased space in New Jersey and Connecticut.

What few expect, however, is more awful news from the

AmEx' Faltering Fortunes

RIISING CHARGES
BAD CARD CREDIT... ...AND FALLING INVESTMENTS
AT AMEX' FINANCIAL UNIT...



ON REVOLVING CREDIT **THIRD-QUARTER ESTIMATE
Data: Company reports, *BusinessWeek*

...HAVE PUNISHED
AMERICAN EXPRESS STOCK



Data: Bloomberg Financial Markets, *BusinessWeek*

the risk than it did a decade ago. And both its core charge-card business and the financial advisory business that Chenault hopes to use as a growth engine by selling mutual funds and other products to the public operate in hotly competitive and heavily glutted industries.

The falling stock price has rekindled rumors that American Express could be acquired by Citigroup, Morgan Stanley Dean Witter & Co., or some other suitor eager to scoop up one of the world's most valuable brands on the cheap. With the company's market value down nearly \$23 billion from when Morgan re-

AmEx At A Glance

TRAVEL RELATED SERVICES

- ▶ **78%** of revenues
- ▶ 2000 revenues: **\$17.4 BILLION**
- ▶ 2000 earnings: **\$1.93 BILLION**
- ▶ This flagship unit markets various American Express Cards as well as Optima and co-branded cards. As the sixth-largest consumer lender in the U.S., AmEx expects write-offs for bad credit to rise higher. Meantime, its corporate and consumer travel business has stalled as well.

AMERICAN EXPRESS FINANCIAL ADVISORS

- ▶ **19%** of revenues
- ▶ 2000 revenues: **\$4.2 BILLION**
- ▶ 2000 earnings: **\$1.0 BILLION**
- ▶ Markets financial advice, mutual funds, insurance, and annuities through a salesforce of 11,000 financial planners. Manages assets of about \$250 billion. Investments in high-yield junk bonds led to more than \$1 billion in write-offs in the first half of 2001. More losses likely as investment-grade bonds go bad.

AMERICAN EXPRESS BANK

- ▶ **3%** of revenues
- ▶ 2000 revenues: **\$591 MILLION**
- ▶ 2000 earnings: **\$29 MILLION**
- ▶ Offers private and corporate banking. Roughly \$5.3 billion outstanding in worldwide loans.

company's \$34 billion pool of investments that it manages for itself. AmEx still has about \$2.7 billion in junk bonds, and more of its top-shelf investments could easily slip into the red zone. As much as a billion dollars of the portfolio at its Financial Advisors unit, for example, is tied up in travel and insurance industry debt. Defaults there are inevitable. Merrill Lynch & Co. estimates an additional \$22 million write-off will be necessary to cover junk-bond losses, but the number could prove to be much larger.

Asked if AmEx' portfolio problems are behind him,



AmEx cards are just as likely to be paying for groceries

Chenault is now hardly reassuring. "We made what we then believed was a very conservative assumption relative to the economic environment," he says. "With what happened on the 11th, I'm not going to predict what the future will hold."

Most analysts agreed that Chenault lost some goodwill on the Street with the second and larger write-off. "It was an unfortunate situation, and he took it very seriously," says David Hochstim, who follows the company for Bear, Stearns

& Co. "The market has written off 2001 for most companies, including AmEx. But

Cover Story

if we end up with more write-downs, his credibility will be damaged." Chenault has said he was unaware of the risky investments, which were made while Golub was still CEO. Golub would not comment.

PIVOTAL ROLE. Chenault seems neither worried nor frazzled by his misfortune. "I don't feel victimized," he says. "This company has been around for 151 years. We've dealt with a wide range of crises, and at the end of the day, I think I'm up to the challenge."

From the headquarters' building a decade ago, Chenault emerged a star by helping to turn around a drifting and troubled company. The burning question now: Can he do it again? The last time AmEx weathered a recession, in 1991, its card business was losing market share to Visa and MasterCard. Restless merchants were in revolt over the high so-called discount fees—as much as 4% compared with less than half that for Visa—that they had to fork over to American Express on every charge. The Optima card then took a surprise \$155 million hit after a spike in delinquencies forced the company to write off 8% of the Optima card debt.

As president of the domestic consumer-card division, Chenault played a pivotal role in reinvigorating the card business. He moved American Express far beyond its elite but limited niche serving high-end customers who paid their bills in full each month and were charged a hefty annual fee for the privilege. He soothed relations with merchants, in many cases cutting fees. He aggressively signed on retailers like gas stations, discounters, and supermarkets. And he launched a credit-card version of a frequent-traveler program called Membership Rewards that cultivated greater loyalty and higher spending from cardholders. Chenault also vastly expanded the company's exposure in consumer lending by issuing cards that no longer required payment within 30 days. Some of the new cards were co-branded with such partners as Delta Air Lines Inc., and Costco Wholesale Corp. In those deals, American Express got access to the customers in exchange for issuing and maintaining the cards.



Inside, debate raged over Chenault's tactics. Some feared that the charges would erode the card's upscale position the premium-priced plastic.

As the economy soared, Chenault's strategy looked like genius and his career took flight. For eight years, charge-volume zoomed higher and higher—to \$297 billion in 2000, from \$111 billion in 1991. Earnings rose without interruption every year from 1995 until now, hitting a record \$2.8 billion in 2000, with more than \$1.9 billion coming from Travel Related Services, the key card and travel unit. Chenault, a former management consultant, was tapped as vice-chairman in 1997 and as president and chief operating officer in 1999.

AmEx' change of fortune, of course, came at a time of global prosperity in the U.S. The true test of strategy and leadership, however, comes in a downturn. Chenault maintains that strengthening of the company's charge-card network, its expansion into international presence, the broadening of product offerings, and an aggressive effort to reduce costs, make American Express well-placed for a postrecession future. "We are in a substantially stronger position," he argues. "We had a relatively narrow product line,



A Visible Corporate Leader

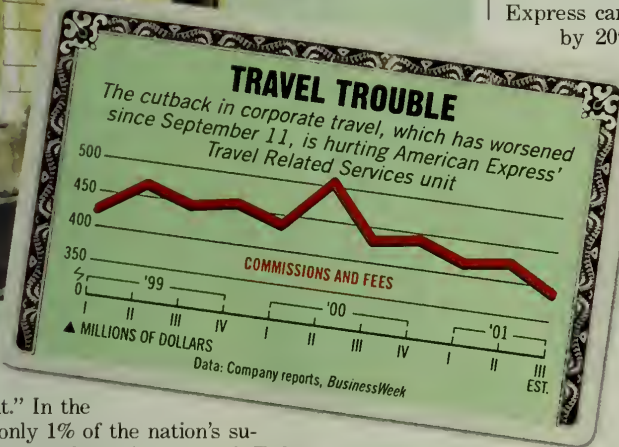
Chenault was at the side of President Bush during a trip to the city and was behind Mayor Giuliani and Governor Pataki when they appealed for more disaster aid

re supermarket than for business lunches



Bad Timing

AmEx widened its exposure in the travel business by buying bonds backed by hotels, airlines, car rental outfits, and the like



dent on vel and entertainment." In the y 1990s, only 1% of the nation's supermarkets accepted the AmEx card. Today, more than allow shoppers to charge their groceries on American press. In the last recession, two-thirds of the company's rge volume came from travel and entertainment. Today, accounts for less than half the charges.

QUANTITY OVER QUALITY. These very "strengths," however, e new and risky vulnerabilities. The company is entering e recession with roughly five times the revolving credit- d debt it had in the previous downturn—\$35 billion vs. illion. By the second-quarter of this year, its write-offs ad card debt reached 5.7%, a level that exceeds the 5.2% rage for all credit cards, many of which lack the prestige eyed by the American Express imprimatur. Those te-offs are also rly 14 times larger n those on its rge cards, where nces are supposed e paid within 30 s. Chenault con- es that credit loss- will rise higher, nsists AmEx will er fewer losses n competitors.

he company's vast unrelenting expan- of cardholders, o now number 54.3 ion, up from 36.6 ion in 1991, has matically altered cardholder base at Ex. To sign up less

affluent customers and to coax less-than-tons merchants such as Arby's and Kentucky Fried Chicken to accept its cards, American Express has had to compete directly in the cut-throat mass market. That pits them against card giants like MBNA Corp., which have been slashing interest rates and fees to win market share.

The result: AmEx' average fees from card members and merchants are falling. So is the average amount of money spent by cardholders, who are also more likely to have problems paying their bills. To expand its revolving-credit business, American Express even purchased the credit-card receivables of the Bank of Hawaii last year, paying a premium price. Some Bank of Hawaii customers balked, though, when AmEx forced them to trade in their Visa cards for American Express cards. Since the purchase, the portfolio has shrunk by 20%.

"They've grown their loan portfolio rapidly, now they're going through an economic downturn and we're going to see how well they've done," says Ken Feinberg, co-portfolio manager at Davis Financial Fund, the third-largest American Express shareholder.

Chenault concedes the company's fortunes are tied to the economy and that investors will have to ride out the cycle with management. He doesn't foresee a recovery until the second half of next year or perhaps early 2003. "Clearly, we're dealing with a downturn in the economy," he admits, "but we were growing share up until the 11th and afterward, and we're growing share faster than the industry."

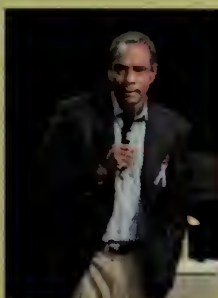
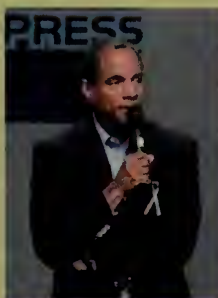
Chenault is right—at least by one measure. Although AmEx has been increasing its market share in the basic credit-card business, it has been

losing ground in what Chenault calls "total plastic spending." The reason: The company is effectively locked out of the fast-growing market for debit cards. Debit cards are linked to bank checking accounts, and MasterCard and Visa have exclusive arrangements with all the U.S. banks.

The upshot is that American Express' share of the value of all U.S. purchases made by credit and debit cards is expected to fall to 17.7% this year, from 19.7% in 1996, according to *The Nilson Report*. Visa and MasterCard now have more than 38 million debit cards in circulation, vs. "a few thousand" from AmEx. Chenault hopes a recent court decision clears the way for AmEx to build relationships with U.S.

banks, but MasterCard vows to appeal the ruling, and the dispute could take years to resolve.

Even then, many U.S. banks may not want to jeopardize their current deals with Visa and MasterCard or their own efforts to get into financial services. The judge's decision is akin to "letting the fox into the hen-house," says Richard M. Kovacevich, CEO of Wells Fargo & Co. Bankers worry that AmEx will poach



Sharing the Grief at AmEx

Chenault comforted employees by word and touch. At one point, he disclosed that he himself had sought counseling to deal with shock, sadness, and anger



Chenault's plan: Cut costs, maintain service

their own customers once they become cardholders, flogging the same investment and insurance products that the banks themselves are selling.

More worrisome, however, is how much of a handle Chenault has on the company's bond portfolio problems at American Express Financial Advisors (AEFA), the unit that accounts for roughly 26% of the company's revenues. Asked pointedly why AmEx would put its money into junk bonds so

risky they are typically referred to as "toxic waste," Chenault is surprisingly vague,

given his reputation for decisiveness and making the tough calls. "I don't know," he says. "This is a strategy that was embarked upon seven or eight years ago. I don't know all the rationale and philosophy."

Some investors are none too pleased. "He didn't say, 'I made a mistake,'" grouses Lewis Rabinowitz, who heads up R. Lewis Securities, a money management firm with an AmEx stake. "He basically said, 'I didn't understand the risk.' I feel that is something that is sort of unacceptable for a CEO."

To be fair, Chenault did take steps to blunt the risks after the first write-off. He cut the company's junk portfolio to about 8% from 12% and decreased the risk of the remaining investments. "We've hit some bumps in the road, and in some cases, we should have responded quicker," says James M. Cracchiolo, CEO of the financial advisory unit. "But we'll be there tomorrow."

Still, the continuing decline in the economy will likely result in more write-offs, especially because AmEx holds nearly \$1 billion in bonds backed by hotels, airlines, insurers, and car rental outfits, which have been hurt by September 11. AmEx owns Royal Caribbean bonds, for example, which are trading at a 25% discount.

Why would AmEx increase its exposure to the same industries its core card and travel businesses depend on? Chenault explains that in the early 1990s, AmEx had a "holding-company mentality" that allowed Financial Advisors to pursue strategies with little regard to the company's core business. "I believe you've got to take a very integrated, holistic approach to risk," he says now. "That clearly was not done in the early to mid-1990s."

AEFA has other, more deeply rooted problems now being addressed by the new leadership dispatched to the division. The mutual funds that the unit manages and sells through its 11,000 financial advisers have been severely outperformed by their peers. AmEx midcap funds, for example, have lost 10% to 22% of their value so far this year and are barely up over a

three-year period, according to Lipper Data Feed Service. T. Rowe Price Associates Inc.'s midcap fund, by comparison, down 13% this year and up 18.5% over the same three-year period. Concedes Chenault: "Our fund performance needs improve." In August, he hired William F. Truscott, a former Zurich Scudder Investments managing director, as chief investment officer.

Truscott's success is crucial to Chenault's hopes to use AEFA as a major source of growth. The chief executive is placing great stock in AEFA's ability to cross-sell investment and insurance products to the company's 54.3 million cardholders. So far, about one-third of the company's financial-planning clients have been harvested from the American Express cardholder base. But this bear market is likely to turn off a lot of first-time investors who already have a glut of mutual funds to choose from.

Chenault's strategy for managing through the recession is simple. He is reducing costs by using technology to process more paperwork and moving back-office functions overseas to places like India. Meantime, he's trying to maintain high levels of service to customers. He is more aggressively building the company's business with major and midsize corporate clients, running their T&E departments on an outsourced basis. Chenault claims American Express is winning 9 of every 10 shootouts with rivals for new corporate card accounts. He says the company is gaining market share by selling "value" and "service" rather than price.

SAD VISIT. It wasn't until two weeks after the terrorist attack that Chenault returned to the American Express Tower, the company's headquarters for 15 years. He toured the eerily dark and vacant structure to get a close-up view of the damage.

He took the freight elevator to his 51st-floor office, peered out the window at the Statue of Liberty, and retrieved the photographs of wife and two sons from the desk and credenza. Other than a light veneer of dust, says, the upper floors were unscathed. "But on the lower floors," he adds, "you see open checkbook or a lost pocketbook. From the objects behind, you see the suddenness of the moment and shock."

There are no management texts to tell CEOs how to guide companies and employees through such a shock. Chenault, like most of his peers, has been operating mostly on instinct since September 11 as he strives to address the immediate trauma and the more ingrained problems at American Express. Throughout, Chenault evinces great confidence. "I don't feel like we're a disintegrated group," he insists in his Jersey City office. "We're going to emerge a stronger and better company." Investors can only hope.

Cover Story



DECEMBER, 1998

Kenneth Irvine Chenault

BORN 1951, New York City

EDUCATION BA 1973, Bowdoin College; JD, 1976, Harvard University.

FAMILY Married to Kathryn Cassell Chenault, a non-practicing attorney. Two sons: Kenneth Jr., 11, and Kevin, 9.

WHERE HE WAS ON SEPTEMBER 11 A business trip to Salt Lake City.

WHAT HE TOLD THE 3,000 EMPLOYEES EVACUATED FROM THE COMPANY'S HEADQUARTERS

"The values of this brand are real, far more real than the bricks and mortar of our headquarters building. The tower does not represent American Express. You represent American Express. All the people of American Express are what this company is about."

MANAGEMENT PHILOSOPHY He invites confrontation and debate. "To me it's not personal. I want you to argue with me."

ON LEADERSHIP "The role of a leader is to define reality and to give hope."

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Ingenuity will get us out.



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ON THE FIRING LINE AT QWEST

It's two Morgan Stanley analysts vs. the telecom in an unusual feud over accounting

BY PETER ELSTROM

The conference calls between Corporate America and Wall Street analysts to discuss quarterly earnings and such often have a sleepy, due-diligence tone to them, with talk of gross margins, cash flow, and the like. But on June 20, Joseph P. Nacchio, CEO of Qwest Communications International Inc., had every listener wide awake as he hammered away at Morgan Stanley Dean Witter & Co. for a research report that questioned Qwest's accounting practices. "I'd like people to make sure they're listening clearly," Nacchio said. "There are no accounting issues or improprieties in Qwest's financial reports. Let me repeat that. There are no accounting issues or improprieties in our reports." In explaining why he felt compelled to hold the conference call, he said, "innuendos on our integrity are not going to be tolerated, irregardless of who makes them, including what I used to believe was a reputable branded firm, Morgan Stanley."

Ouch. At a time when Wall Street analysts are drawing widespread criticism for cozying up to major corporations, the Qwest-Morgan Stanley clash has turned into a highly unusual, public, and nasty dispute. Wall Street firms

tend to avoid pointed criticism of companies because they don't want to lose out on lucrative investment banking business, such as helping a company raise capital or negotiate a merger. For an individual analyst, aggressive research can be professional suicide: After Janney Montgomery Scott analyst Marvin Roffman criticized real estate mogul Donald Trump in 1990, Trump asked for his head, and the firm obliged. Still, since June, Morgan Stanley analysts Simon Flannery and Jeffrey Camp have continued to question Qwest's accounting practices in their research reports.

CREDIBILITY CRISIS. Nacchio, a brash Brooklyn-raised 52-year-old with a street brawler's attitude, has responded blow for blow. At one point, he openly scoffed at the notion that Morgan Stanley's analysts were doing the kind of independent research that analysts are supposed to do. "If I believe that, I'd have to believe in the Easter bunny," he said. "For a firm like Morgan Stanley to be taking this approach with us, while at the same time they have strong buys on companies that have large financings in front of them, would make me look twice."

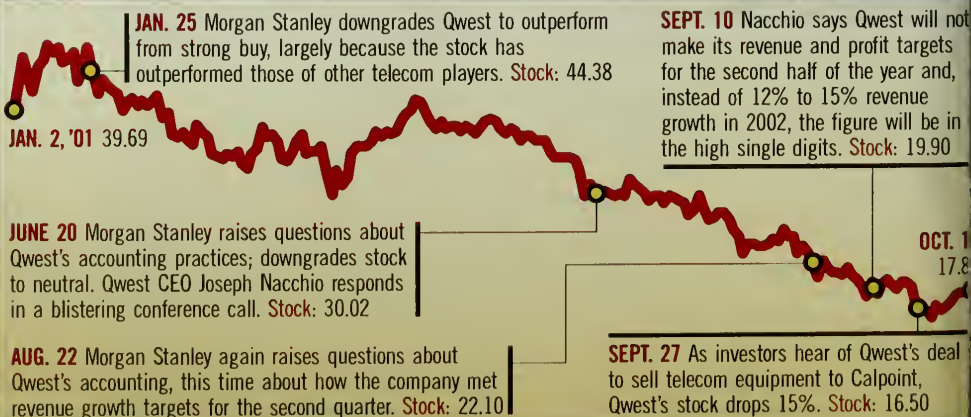
These days, however, it's Nacchio's credibility that is under fire. The central argument that Flannery and Camp made was that Qwest was using accounting

practices that, while legal, were so aggressive that it would be difficult for Qwest to hit future revenue and profit growth targets. A host of Wall Street firms, including Salomon Smith Barney and Credit Suisse First Boston, jumped to the company's defense. But on Sept. 10, Qwest conceded it wouldn't make its revenue and profit targets for the second half of 2001 and would show revenue growth in the "high single digits" next year, not the 12% to 15% promised. "We're proud of these analysts for uncovering an out-of-consensus view that turned out to be right," says Mayree C. Clark, Morgan Stanley's head of global research, who says the firm's research is independent of its investment banking.

The sharp-penciled analysis helped Morgan Stanley's reputation at a critical time. The firm took a hit for research during the Internet boom the nonstop cheerleading of Net analyst Mary Meeker. Even some Qwest's shareholders give the investment banking firm kudos, despite having lost money on Qwest stock. "They were the first to report on the growth issues," says Brian B. Hayward, manag-

QWEST'S SLIDE

Shares in telecom player Qwest have tumbled since the beginning of the year in the wake of questions about its accounting practices and a deterioration in the telecom industry



Data: Bloomberg Financial Markets



from the outset our concern was what the accounting was telling us about the sustainability of [Qwest's] revenue and operating income.??

GREY CAMP and SIMON FLANNERY, analysts at Morgan Stanley, in a report on Qwest

the Invesco Telecommunications and, which counts Qwest among its 10 holdings. "That's the idea [of research]." Abraham Bronchtein, a New York money manager and shareholder, wrote a letter to Nacchio arguing that Morgan Stanley had performed appropriate and timely service."

OVER BAIT? Nacchio, however, is seeing nothing. When he lowered his financial projections on Sept. 10, he pointed out that the change was not due to accounting issues raised by Flannery and Camp. Rather, he said, it was because the economy in the 14-state territory where it has local telephone operations, as a result of its acquisition of US West Inc. last year, had suddenly slowed. Nacchio has said that the accounting issues are irrelevant and don't have any impact on Qwest's ability to generate revenues or cash flow.

Nacchio declined to comment for this article, but at an investor conference earlier this month, he argued that Qwest is stronger than ever once the econ-

omy recovers. "We look like the kind of company the industry is going to look like three years from now," he said. "We're on the cutting edge."

Nacchio has a lot of work to do to restore Qwest's luster. At the beginning of this year, Qwest looked like a sure survivor in the telecom industry's increasingly brutal shakeout. It had the combination of cash-producing local assets and a cutting-edge national network that every major telecom player was shooting for. And it sported a \$70 billion market cap that would have allowed it to get even bigger by, say, making a run at long-distance and wireless power Sprint Corp. or combining with BellSouth in a merger of equals. Now, with its market cap down to \$30 billion, Qwest could be takeover bait. The steep decline is largely because investors realize Qwest is suffering the same problems as everyone else in telecom. However, based on stock price-to-cash flow ratios, there is a 10% to 20% discount relative to other Bells, largely because of concerns over ac-

counting issues. "The market is telling you the company has a credibility problem," says Hayward.

Who are the analysts who have taken on Nacchio? Camp is a young hotshot who, at age 32, has won the top spot in *Institutional Investor's* prestigious ranking of equity analysts for the past two years. The Michigan native covers Internet infrastructure services—including Web hosting and high-speed Internet access—after spending four years in Hong Kong evaluating Asian telecom companies for Morgan Stanley. Flannery, a cherub-faced Irishman who arrived at Morgan Stanley from J.P. Morgan & Co. in 1999, covers major U.S. telecom companies. The 39-year-old made his name at J.P. Morgan sizing up Latin American telecom companies, winning the top *Institutional Investor* ranking in that category in 1996, 1997, and 1998. They jointly cover Qwest because the company is both a traditional telecom carrier and a provider of Internet services.

QUESTIONS. Qwest and Morgan Stanley haven't always been at odds. In 1999, Qwest helped select Morgan Stanley for the lead role in the initial public offering of KPNQwest, a European telecom network jointly developed by Qwest and

Dutch national phone company KPN. Even at the beginning of this year, Flannery and Camp were pretty big fans of the company and of Nacchio. At the start of January, they rated Qwest's stock a "strong buy," the firm's highest rating. When the pair decided to downgrade the

stock one notch to "outperform" on Jan. 25, they took pains to explain that it was because Qwest's stock had soared so high that its valuation had gotten ahead of its telecom peers.

Over the next few months, a series of events prompted Flannery and Camp to take a closer look at Qwest. In February, Qwest Chief Financial Officer Robert S. Woodruff decided to leave the company to spend more time with his family. In March, the company filed its first annual report with the Securities & Exchange Commission since the merger with US West. In April, it reported first-quarter results that were better than its peers. And through the spring, Nacchio and several other top executives were selling shares. Nacchio sold more than 4 million shares in the 12 months ended that June for a total of \$183 million, according to Thomson Finance/First Call, which he said was to diversify his financial holdings. "Almost as a matter of course, we started to look through it," says Camp. "We hadn't

come to any conclusions. We had some follow-up questions for the company."

To help, Flannery and Camp turned to Trevor Harris, a Columbia University professor of accounting and head of Morgan Stanley's accounting research group. Together, the trio dug up examples of where they felt Qwest was using aggressive accounting that made its financial statements look better than they would with a more conservative approach. For example, they noted that Qwest carried its investment in KPNQwest at more than \$7 billion—even though KPNQwest shares had tumbled so precipitously that the market value of the stake was less than \$2 billion.

"DISAPPOINTED." What's more, Qwest had made changes to its pension plans that Morgan Stanley found troubling. Last year, for instance, Qwest boosted the average return it assumed it could get on plan assets to 9.4%, from 8.8%. The result: Qwest's pension assets were figured to be growing much faster than its costs, allowing it to report income from its pension plans. Overall, the changes enabled Qwest to report income from its pension funds of \$405 million in 2000. The company "has moved from having the most conservative assumptions [of the Bell companies] to among the least conservative," Flannery and Camp wrote. While



"Innuendos on our integrity are not going to be tolerated, irregardless of who makes them, including what I used to believe was a reputable firm, Morgan Stanley."

— JOSEPH P. NACCHIO,

Chairman and CEO of Qwest

each accounting item may not have been significant, Morgan Stanley felt that, in total, they suggested Qwest was straining to make its numbers. In a June 20 report, the analysts detailed their concerns and downgraded Qwest's stock, this time to "neutral."

Nacchio exploded. He called a conference call for June 20—never mind that he had held one the day before to reiterate that Qwest expected to make its financial projections for 2001. "I'm extraordinarily disappointed with what I consider unprofessional and irresponsible behavior from a major investment bank," he said.

Robin Szeliga, Qwest's new chief financial officer, then rebutted the Morgan Stanley report point by point. She conceded that Qwest would write down the value of its stake in KPNQwest, but said it would be \$4.8 billion because that was the value suggested by an independent appraiser. On the pension plan, she said the assumed return figure was simply average for the telecom industry. Qwest's stock sank 4% that day, but after several other analysts issued reports critical of the Morgan Stanley research, it recovered to its previous level of \$37 a share by the end of June. Even with

QWEST'S BOOKS: UNDER THE MICROSCOPE

Two analysts at Morgan Stanley Dean Witter are in a dispute with Qwest CEO Nacchio that has erupted into a public battle over the company's prospects and management's credibility. Here are some of the key issues:

KPNQWEST

MORGAN STANLEY CLAIMS In a June report, the firm argued that Qwest's stake in KPNQwest, a European telecom network, had to be written down because it was carried on the books at more than \$7 billion, even though its market value had dropped to less than \$2 billion.

QWEST'S RESPONSE On June 20, Qwest said it would write down KPNQwest to \$4.8 billion because that's what an independent appraiser said it was worth. However, in July, it decided to write down its stake to \$1.3 billion. It later explained it wanted a "very conservative treatment" of the holding.

CONCLUSION Morgan Stanley got it right.

PENSION ASSUMPTIONS

MORGAN STANLEY CLAIMS Qwest made more optimistic assumptions about its pension plan. For example, it boosted the return on plan assets to 9.4%, from 8.8%. The result: Qwest could report credits in its pension plans as income.

QWEST'S RESPONSE It was only changing pension assumptions to get them in line with other companies. It hammers Morgan Stanley for not detailing the assumed rates of return at other telecom companies.

CONCLUSION Morgan Stanley concedes that Qwest's assumed rate of return is in line with other telecoms. But the firm says it is concerned that Qwest moved from conservative accounting to a riskier approach.

SELLING OFF CAPACITY

MORGAN STANLEY CLAIMS Qwest was boosting revenue growth through unsustainable means. It cited Qwest's selling of pieces of its network, something called indefeasible rights of use (IRUs). Qwest's revenue growth in the second quarter was 12.2% with the capacity sales, but 7.5% without them.

QWEST RESPONSE The IRU sales are part of its normal business. It says it has so much capacity that there is no chance it will run out in the foreseeable future.

CONCLUSION On Sept. 10, less than a month after Morgan Stanley's claims, Qwest conceded it won't make its financial targets this year because demand—for IRUs, among other things—dropped.

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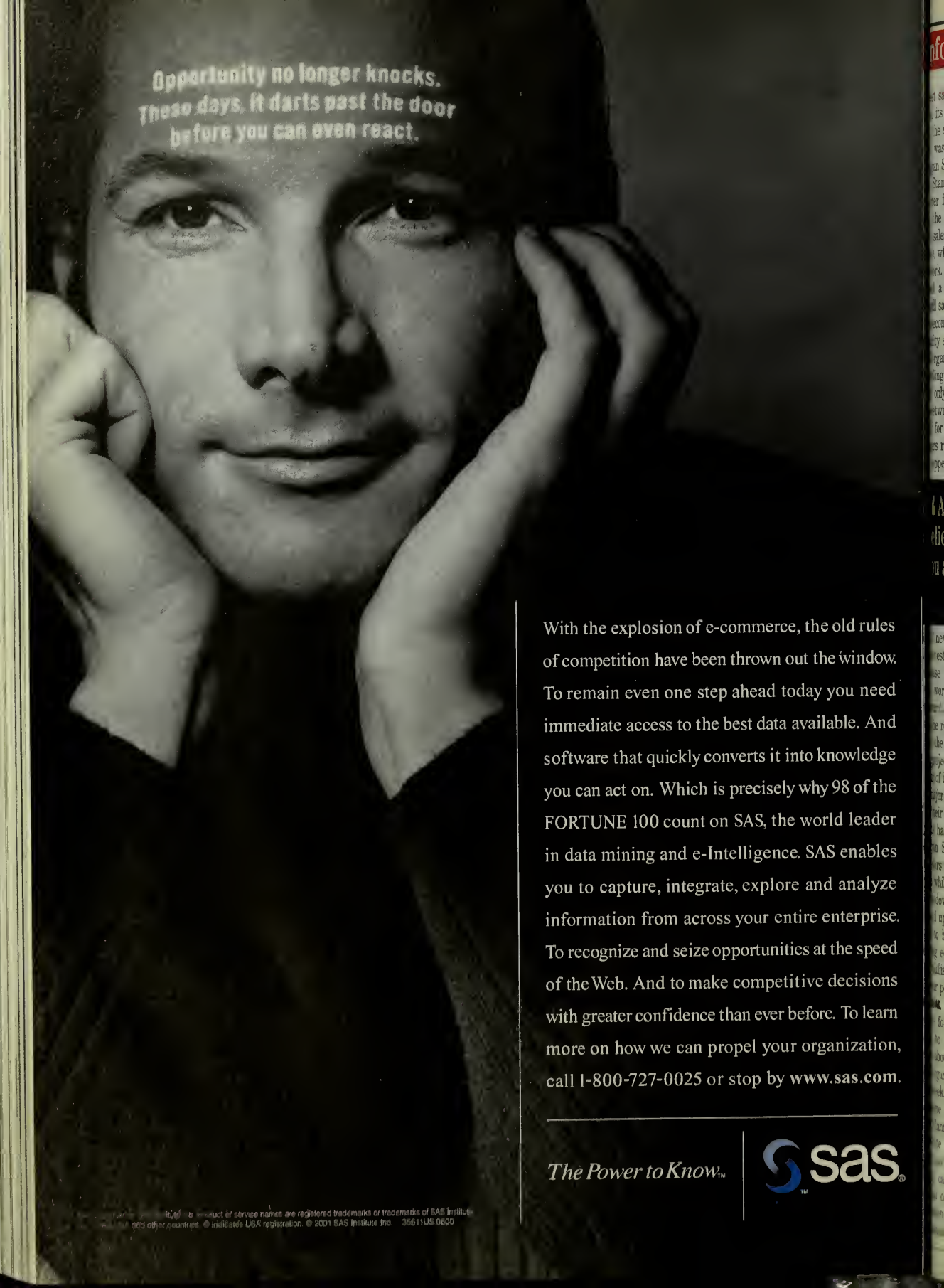
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est said in July that it would write
its stake in KPNQwest to \$1.3 bil-
lion, the stock held up.

It was another story after the next
Morgan Stanley report. In August, Mor-
gan Stanley dug into Qwest's second-
quarter financial statements and found
that the company had more than dou-
bled sales of indefeasible rights of use
(IRUs), which are slices of capacity on its
network. The increase was so large that
it had a big impact on the company's
overall sales: Qwest's revenue growth in
second quarter was 12.2% with the
IRU sales, but 7.5% without them.

Morgan Stanley said the trend was
disturbing for two reasons: First, Qwest
could only sell so much capacity because
the network is finite. Second, the de-
mand for IRUs was drying up as telecom
companies ran into financial trouble. Nac-
chio appeared on CNBC arguing that he

optical technology, and Qwest would
market those services to its own cus-
tomers. As part of the deal, Qwest
would buy telecom gear, mostly from
optical player Ciena Corp., and then re-
sell it to Calpoint. When investors called
Qwest to get more details, they found
out that Qwest was planning to book
as much as \$300 million in revenues
from the deal—even though selling
equipment is hardly Qwest's business.
One portfolio manager, who cannot
speak on the record because of his firm's
press policies, was incredulous. "Maybe
[Nacchio] does need stuff like this to
make his numbers," he said. "What else
is he doing that we don't know about?"
During the last week of September,
Qwest's stock slid to \$16.70.

The following Monday, Oct. 1, Nacchio
hastily arranged another conference call
to explain the Calpoint deal. He said

**“Anything I tell you, you’re not going to
believe anyhow. We’re obviously under a cloud.
You all think we lie, cheat, and steal.”**

— CEO NACCHIO, speaking to institutional investors

ld never run out of optical capacity,
investors grew nervous. "[The steep
decrease in IRU sales] was what was
most worrisome to us," says Invesco's
Howard. Qwest shares dropped 5% the
day the report came out, to \$22.10.

By the time Qwest lowered its finan-
cial projections on Sept. 10, there was
little doubt of inevitability to it. Virtually all
major telecom companies were miss-
ing their earnings targets. Many up-
dates had filed for bankruptcy. And
Morgan Stanley's reports had primed
investors that Qwest could disappoint.
While explaining how the econom-
ic slowdown had hit Qwest, Nacchio re-
peatedly upbeat. "In the short term, we
have to be conservative, reflecting a
fragile economy," he said. "I am still
bullish about this industry. I really
like our position. I like our assets."

SUAL DEAL. In a sense, it was a
chance for Nacchio to wipe the slate
clean, to start over and let investors
forget about the accounting issues raised
by Morgan Stanley. That didn't happen.
A few weeks later, another accounting is-
sue came up—and this one didn't start
with Flannery and Camp.

In late September, several investors
learned second-hand that a small telecom
company called Calpoint LLC had cut an
equity deal with Qwest. Under the
agreement, Calpoint would develop
communications services based on new

the agreement was designed to mini-
mize Qwest's expenses by having an-
other company make capital investments
and that Qwest was buying the equip-
ment for Calpoint because Qwest could
get bigger discounts than a tiny up-
start. And he backed down from count-
ing the Calpoint deal as general rev-
enues, saying he would break out any
revenues received from the arrange-
ment. "It will not be used to confuse
our gross margins, our net margins, our
revenues," he said.

These days, Nacchio seems to have
lost some of his fight. At a Goldman,
Sachs & Co. conference on Oct. 3, he
sounded almost despondent as he spoke
to institutional investors. "Anything I
tell you, you're not going to believe
anyhow," he said. "We're obviously un-
der a cloud. You all think we lie, cheat,
and steal." Still, he vowed to pull Qwest
out of its current troubles. "We'll let
the numbers speak for themselves on
Oct. 31," when the company reports
third-quarter results.

Even though they've won the respect
of many investors, Flannery and Camp
aren't celebrating. They know that Mor-
gan Stanley's relationship with Qwest
is badly damaged. Both say they would
like to repair it. "Their input is critical
to what we're doing," says Camp. Mak-
ing tough calls on Wall Street has never
been easy. ■

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BANKING

BANK ONE, TAKE TWO



Jamie Dimon's big changes have restored profitability. Now, he's trying to turn the Chicago bank into a nationwide powerhouse

Fired from his post as Citigroup president in 1998, spurned by Sanford I. Weill, his longtime mentor there, and unsure about where to go next, James Dimon did what any frustrated 42-year-old New Yorker would do: He took up boxing. "Mind, body, and soul, you can't think about anything else," Dimon says. "Your whole world is what is in front of your hands and your face. I loved it."

Eighteen months ago, Dimon stepped out of the ring and took up another all-consuming challenge: turning around Bank One Corp., the badly managed, financially struggling bank based in Chicago. Bank One, now the nation's sixth-largest in terms of assets, is the result of a 1998 merger between First Chicago NBD Corp. and

Banc One, a deal between two companies with different—and antagonistic—cultures. Dimon has put an end to that tension, mostly by letting go of senior executives from both sides, while also making the \$270 billion bank profitable again. Even Nancy A. Bush of Ryan, Beck & Co., one of Bank One's many critics on Wall Street, says: "It clearly is a better bank now."

For Dimon, who sank nearly \$60 million, almost half his personal fortune, into Bank One stock, better is hardly

enough. To thrive in the eat-or-be-eaten financial services arena, he knows the bank has to expand. And shareholders are becoming increasingly impatient that it has done so. Investors have pushed the company's stock down from \$39 in June to about \$33 now, about \$5 more than the price before Dimon joined on Mar. 27, 2000. "I love Jamie. He's a good manager. But, you know, this is a tough nut to crack," says David Drem, chairman and chief investment officer of Diman Value Management LLC, which has pared its stake in Bank One 14% since April, to 1 million shares.

PLASTIC WOES. Dimon hopes that he can turn the economic slowdown into Bank One's advantage by buying distressed banks and other financial outfits, perhaps by yearend, he tells *BusinessWeek*. This is familiar territory for Dimon. He helped Weill build Citigroup's empire over the years. "We're getting closer and closer," says Dimon. "We will be on the acquisition trail in a prudent way."

Prudence will certainly be called for. As at most other banks, war worries are weakening customers and unsettling investors. Between the first quarter of 2000, when Dimon joined, and the third quarter of 2000, nonperforming loans jumped from \$1.1 billion to \$3.1 billion and they'll probably keep climbing as business distress deepens. Likewise, anxious consumers seem sure to spend less in coming months, making the lack of growth in the bank's long-troubled \$66.8 billion credit unit, First USA, more nettlesome—

JAMES DIMON

BORN Mar. 13, 1956, New York City

EDUCATION BA, psychology and economics, Tufts University, 1978; MBA, Harvard Business School, 1982

FAMILY Met wife, Judy, at Harvard; they have three daughters

POSITION Chief executive, Bank One

FAVORITE QUOTE "Sir, when the facts change, I change my mind. What do you do?"—John Maynard Keynes

AFTER HOURS Recently took kickboxing lessons, along with one of his daughters



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pecially since nearly one-third of Bank One's earnings historically have come from there. By contrast, at Citigroup, which runs the nation's biggest credit-card business, plastic accounts for less than 23% of profits. For Bank One, earnings overall in the third quarter hit \$754 million, up from \$581 million in the same quarter a year ago.

But Bank One's gloomy short-term prospects ignore the overhaul that Dimon has engineered. His top-to-bottom recasting and cost-cutting has put Bank One into the kind of fighting trim that could get it through tough times. By reducing the company's staff by about 8,000, to 75,800, Dimon has slashed its annual expense base from \$10.6 billion to \$9.2 billion, and further layoffs should bring that to \$9 billion or less by yearend. Dimon has been able to close a costly call center that was helping handle the huge number of First USA customer complaints: Dissatisfaction levels with credit cards have fallen from 26% in late 1999 to just 16%. And he has made it a priority to mesh no fewer than six computer systems so that customers in Detroit, for instance, can easi-

ly cash checks in Dallas. Aside from the obvious consumer benefits, the move should lop another \$200 million annually off costs by the end of 2002. Most important, Dimon has bulked up reserves so he can better absorb loan losses. Bank



SAYS FORMER MENTOR WEILL (RIGHT): "I'M A BIG FAN"

Dimon and Weill built the Citigroup empire over 16 years

One has set aside \$4.5 billion, or 2.73% of its loans outstanding, giving it a bigger cushion than most of its rivals.

Such moves will go far to shore up Bank One's profitability—which bank executives figure could still be preserved if prospects for the economy turn far darker. Even the most gloomy analysts expect the company will earn \$2.8 billion this year, compared with a loss of \$511 million last year. And if times worsen, Bank One should still earn some \$2.9 billion next year, says

Prudential Securities analyst Michael Mayo, who since May, 1999, has advised investors to sell the bank's stock. "Jamie Dimon is an uptick for firm," says Mayo, "but we still believe he inherited a much weaker franchise than he or anyone else could have predicted."

SECOND CHANCE. Actually, Harvard Business School graduate knew exactly what he was getting into. After being recruited by Weill—both say they clashed amid the strain of merging Travelers and Citicorp—Dimon mulled over several possibilities. He rebuffed overtures for senior positions at Amazon.com, Home Depot, and Barclay's. Bank One chief appeal: As a 14-state banking "reform," it gives him a second chance to build a national financial powerhouse. Weill, now reconciled with Dimon, is confident his former protégé will succeed. Says the Citigroup chief executive: "I'm a big fan."

Dimon is following a road map similar to the one he and Weill sketched out in the mid-1980s when he was Weill's right-hand man and chief number cruncher. They started by fixing C



ial Credit, a troubled \$4 billion-a-
insurer and lender, and then buy-
merica Financial Services Group
ding Smith Barney), Shearson
an Brothers, Travelers, and finally
orp. Dimon, hoping to do much the
at Bank One, is betting that dis-
sales in the coming year could
him. "The best
anies will be
ctors in bad
," says Dimon.
you don't want
e the biggest
dumbest. You
to be the
st and most
eted."

r all his ambi-
though, Dimon
atious. Robert
p, who also helped build Citigroup,
it was Dimon who labored over
due diligence when Weill & Co.
acquisitions: He "was the one who
sure people didn't get carried
" says Lipp. Indeed, Dimon—who
out hurried bits of sentences and
e office has on display "No Whin-
signs and a four-star general's hel-
has made only one purchase so
n July, he bought \$6.2 billion in
-card receivables from Wachovia
, cementing First USA's position as

the nation's third-biggest credit-card op-
eration. Now, he says, he's looking at
middle-market banks, other credit-card
portfolios, and asset-management firms.

As Dimon learned working cheek-by-
jowl with Weill, a cohesive team is cru-
cial, and he says the senior manage-
ment is finally jelling: "It's exponentially

company does. And Dimon has instilled
accountability all the way down to the
local branches, setting up profit-and-loss
statements for each and doling out hefty
bonuses for top performers. Says direc-
tor John R. Hall, a former acting chair-
man of Bank One who recruited Dimon:
"Jamie has brought his own culture to
the bank."

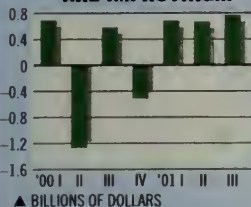
Dimon's business
savvy has been
years in the making
and has brought
with it some odd
moments. As a
teenager, he worked
summers for his
dad, Ted, a New
York stockbroker.
Years later, Dimon
indirectly oversaw

his father at Salomon Smith Barney.
"He would never admit I was his boss,"
laughs Dimon. "But no broker would
ever admit you're their boss."

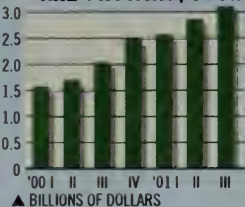
During his years with Weill, Dimon
learned plenty of management lessons:
Solve problems quickly. Demand prof-
itability fast. Be bold. At Bank One, he
has followed two of those maxims to
good effect. Now, after a year and a
half of laying the groundwork, he has to
be bold. Or learn to be content as No. 6.

By Joseph Weber in Chicago

BANK ONE'S PROFITS ARE IMPROVING...

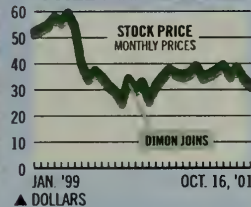


...BUT BAD LOANS ARE GROWING, TOO...



Data: Bank One, Bloomberg Financial Markets

...AND INVESTORS ARE STILL FEELING GLUM



becoming more fun—because of the
people." Dimon quickly replaced top ex-
ecutives who couldn't put up with the
long hours and close cooperation he re-
quired, and he shook up the responsi-
bilities of others. Among those he wooed
to Bank One is the chief financial officer,
Charles W. Scharf, who left Citigroup.

Dimon has deliberately upended some
of the bank's old practices. Before, top
executives were paid handsomely
whether the bank thrived or not. Now
their pay turns on how well the whole

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A DEBT TRAP FOR THE UNWARY

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NOT FOR PROFIT?
He insists there was "nothing untoward" about his \$331,000 salary at Genus

BERNALDO DANCEL



STUNG
AmeriDebt pocketed much of his payment money as "voluntary contributions"

ROBB TOPOLSKI

actions. Many buy names of indebted customers from mortgage and financial companies or use high-pressure sales tactics to sign them up. "I get people at a vulnerable time," Kristy Welsh, who runs Credit Info, a financial-advice Web site. The clients' vulnerability only increases. In Willsboro, N.Y., electrician W. Pedro saw his debt load grow signing on two years ago with the credit agency, Genus Credit Management in Orlando. He was \$9,000 in debt after making home repairs, paying them with costly finance-company cards and borrowing on high-interest credit cards. Genus promised to make him debt-free in 40 months. But, says Pedro, fees and late charges started piling up, apparently because his monthly

payment was set too low. By the time Pedro pulled out, his debt had grown by \$1,000, he says. "A lot of these companies are out there preying on people's financial misfortunes, and they call themselves 'nonprofit,'" says Pedro. Genus spokesman Tim Raftis declined to discuss specific cases but says the agency's overall record is "very exemplary." Genus has now sold its accounts to another agency.

LAVISH SALARIES. Another of the nation's largest agencies, AmeriDebt Inc. of Germantown, Md., is also a target of frequent complaints. Last year, facing \$20,000 in credit-card debt, Robb Topolski turned to AmeriDebt, attracted by its nonprofit status. The Portland (Ore.)-area chip-plant supervisor says he was stunned when AmeriDebt pocketed his

entire first payment as a "voluntary contribution." And he was shocked to learn it was collecting nearly 10% of his payments as continuing contributions. He concedes he should have read his contract more closely but says his AmeriDebt representative never disclosed the fees as he applied pressure for Topolski to sign quickly. AmeriDebt's levies put Topolski behind with one creditor, triggering late fees. Disgusted, he quit in April. "Understand—they're not doing credit counseling," he says. "They're just passing through your money and skimming some off the top for themselves." The agency's attorney, Julian H. Spierer, says the complaints are typical for any business but "quite few in number" given AmeriDebt's size and visibility.

Although agencies are tax-exempt because they're supposedly operating in the public interest, many seem just as keen to serve private interests. Lavish salaries are common. The head of Genus until 1998, Bernaldo Dancel, a brash Air Force veteran who says he got into the business after suffering his own bankruptcy, drew big salaries, reaching \$331,065 in 1996, according to Genus' federal tax filings. Likewise, Credit Counselors of America, based in Phoenix, paid its president, Michael Hall, \$397,466 in the year ended June

As Consumers Get Deeper In Debt...



...Millions File For Bankruptcy



Data: Federal Reserve, Administrative Office of the U.S. Courts

Customers who divulge some of their most private information to counseling agencies may be surprised who gets access to it

30, 2000, according to its federal tax filing. By comparison, the average top salary nationwide for comparable nonprofits is \$134,000, according to Abbott, Langer & Associates Inc., a Crete (Ill.) compensation consultancy. Hall says his salary was reasonable; Dancel that there was nothing untoward about his.

The brass at agencies often indulge in what seems to be self-dealing in the purchase of real estate, supplies, and services. Such arrangements, says Rushkoff, are "just a new way to get the money out of the nonprofit and into the for-profit." For instance, Credit Counselors of America bought its building from its president, and has paid at least \$461,909 in accounting fees to the company of one of its directors over two years. Hall says the fees and the real estate transaction were appropriate. "I don't think there's been anything to be concerned about," he says. "[We] have good controls."

STEERING. While Dancel was at Genus, the company supported, and later bought out, a for-profit company that Dancel established, Freedom Network International of Howard County, Md., which claimed to offer discounts on consumer purchases. Dancel used money borrowed from Genus, along with transferred assets and personnel, to launch a for-profit venture, Amerix Corp. of Columbia, Md., according to interviews and tax filings. Amerix, which provides computer services to manage transactions between consumers, counseling agencies, and many thousands of creditors, quickly went on to do at least \$123 million in business with Genus over three years, according to agency documents. Dancel says he doesn't recall the deals, although documents filed with the state place him in the middle of the action. He says Amerix got no support from Genus and that all his dealings were proper.

In another case, DebtWorks Inc., a Germantown (Md.) for-profit company founded by Andris Pukke, received at least \$2.2 million in business from AmeriDebt, starting when his wife Pamela was president. AmeriDebt also steers customers to a for-profit mortgage company with links to Pukke, according to corporate filings. Pukke and an AmeriDebt attorney insist there is nothing improper about AmeriDebt's

business with Debtworks, and that Pukke's wife, who has left AmeriDebt, was not involved in the decision to give business to her husband's company.

In 1999, the Office of the Corporation Counsel accused Pukke of using AmeriDebt to create business for a related for-profit finance company by charging fees for promised loans that

depended by the the Ohio Comm. Dept.'s Securities Div. two years after acknowledging in a consent order that he made unauthorized sales of securities involving one company went bankrupt and another in trouble with regulators in several states. Voss says the incident was a one-time misunderstanding and that he "wasn't trying to rip anybody off."

Before becoming a director of Cambridge Credit Counseling Corp., Agawam, Mass., Richard J. Puccio, a former securities lawyer, was charged with securities laws. In 1996, the Securities & Exchange Commission barred him from the securities industry for at least five years for participating in a boiler-room scam at Strickland Oakmont Inc. "Puccio's conduct could hardly be considered serious," the SEC said in a ruling. Cambridge Credit Counseling attorney Paul Kaplan acknowledged the offense but said Puccio doesn't deal with consumers or handle their financial affairs. **NO DEAL.** With problems mounting in the industry, and other creditors are drawing a tougher line: refusing to deal with some agencies, charging fees generally, and stopping rebates on payments to others. "There are clearly scrupulous agencies out there that we won't do business with anymore," says L'Abbate, senior vice-president for payment processing at Morgan Chase & Co.

That doesn't help consumers much. Many of the agencies with which the banks will still deal are demanding more "voluntary contributions" from consumers. Fees vary, but they usually consist of a set-up fee of \$100, or the equivalent monthly payment plus a smaller monthly fee. Voluntary counseling was a sleepy cottage industry for a long time. Now, larger and bled, it may be more in need than clients of being set back on the straight and narrow.

By Christopher H. Schmitt in Washington, with Heather Timmons in New York



GETTING WISE Consumer-protection watchdogs have started to track fraud

MARYLAND OFFICIALS FRIEDMAN AND TORRICO

never materialized. The finance company, Infinity Resources Group Inc., last year agreed to pay about \$2 million in refunds to 10,000 customers across the country, according to a consent order. Pukke says both cases were unfair, and he was a victim when lenders failed to live up to agreements with him.

Customers who divulge some of their most private information to counseling agencies may be surprised who gets access to it. It's not unusual for top agency executives to have violated securities and other laws. Gary A. Vosiek, president of Trinity Credit Counseling in Cincinnati, had his securities license sus-

COMMENTARY

By Gary Weiss

WHY THOSE HEDGE FUNDS ARE GETTING TRIMMED

War, terrorism, disorder—for hedge fund managers, these should be grand times. Since these money managers for the wealthy can invest in just about anything, and can use borrowed money to leverage their bets, crises can turn them into overnight legends—or ruin their careers. Hedge funds performed spectacularly during the Gulf War and the European currency trails of 1993, but were humiliated by the emerging-markets crisis of 1998. So in the midst of national trauma, one might reasonably conclude that hedge funds would be princes or rogues. One would be wrong.

The results are in from September, and they are stunning in their lack of anything stunning. Hedge funds are doing well this year, but only by losing less than other investments. In contrast to the Standard & Poor's 500-stock index, which fell 1% in September, hedge funds fell 7.8%, according to Hennessey Group LLC, a consulting firm that specializes in hedge funds. The numbers from Hennessey and other trackers show hedge funds beating the indexes year to date, but failing to move into the plus column. Says Charles J. Gradante, Hennessey's chief executive officer: "Last year was a bad year and hedge funds were making money. This year was a bad year and hedge funds are not making money."

Clearly, these investment managers or the wealthy seem to have lost their raison d'être—to make money for their investors even when the rest of the world is suffering. And that is not a pipe dream by any means. In 2000, as the S&P fell 11%, hedge funds gained 7.8%, according to Hennessey.

Why is hedge fund performance so uninspiring? One reason is that the funds have learned well the lessons of Long-Term



Capital Management, which collapsed after employing heavily leveraged currency and trading strategies in the summer of 1998. "Hedge funds this year have had a defensive posture," says Antoine Bernheim, publisher of the *U.S. Offshore Funds Directory*. And it shows.

This hesitancy is evident in the lackluster performance of high-rolling "macro" funds, which buy and sell currencies as well as stocks—and often use leverage to goose their returns. The biggest names of the hedge fund business in the past, such as George Soros, Michael Steinhardt, and Julian Robertson, all ran macro funds. Their counterparts today are down 5% this year, and declined 1% in September alone. While that's good

news for the financial system—because it shows macro funds are taking more care in managing their risk—those are awful numbers compared with the past. In 1993, Soros' multibillion-dollar Quantum Fund gained 69%, much of it from betting on the decline in European currencies. None of the remaining large hedge funds is performing so handsomely. At the Pequot Capital Management hedge fund group, one of the largest, its flagship Pequot International hedge fund is flat so far this year, Bernheim notes.

SHORT OF PIZAZZ. The dearth of leverage is also evident from the performance of funds that sell stocks short, wagering on a decline in prices. Short-sellers were the leading fund group in September and in the year to date—but did not perform with a great deal of pizzazz. In September, short-only hedge funds gained 11%, and they are up 16% so far this year. That's roughly in line with the decline in the market averages—meaning that the funds are not doing any better than an investor who simply sold an index product short.

To be sure, hedge fund investors are not suffering as badly as others. But considering the hefty fees they pay—usually 20% of profits, plus 1% of assets—they have a right to expect more than an absence of losses. But there's a reasonably good chance that this fallow period may linger for a while. Hedge funds are victims of their own past successes. A cottage industry just a decade ago, they are now a sizable part of the financial-services industry, with assets exceeding \$400 billion. Gradante notes that there are just too many funds trying to exploit the same inefficiencies.

Until hedge fund managers overcome that problem, and their own timidity, their well-heeled investors are as likely to be as down in the dumps as everyone else.

Senior writer Weiss covers finance.

THE BEST HEDGE-FUND STYLES

2001 TOTAL RETURNS THROUGH SEPT. 30

SHORT-BIASED	10.7%
CONVERTIBLE-ARBITRAGE	0.9
FIXED-INCOME	0.7
DISTRESSED	0.3
MULTIPLE-ARBITRAGE	-0.1

AND THE WORST

LATIN AMERICAN	-15.2%
EMERGING-MARKETS	-4.2
HIGH-YIELD	-3.7
HEALTH-CARE & BIOTECH	-3.4
VALUE	-3.3

Data: Hennessey Group

GAP: MISSING THAT OL' MICKEY MAGIC

Bad fashion calls and an exodus of execs have Mickey Drexler's retail empire hurting

BY LOUISE LEE

For most of us, polo shirts peaked in popularity back in the mid-1990s. But somehow, fashion guru Millard S. "Mickey" Drexler became captivated by them last year. The chief executive of Gap Inc. insisted that his Gap-brand stores carry deep inventories in an unusually wide palette of colors. Gap merchandising managers, unable to dissuade him from the idea, produced data suggesting that three or four colors account for the vast majority of sales. But Drexler was adamant, saying he didn't want to miss a sale to an XXL customer who wanted the shirt in purple. While Gap defends the plan as having "brought fashion to a basic item," the off-beat colors bombed. Stores wound up with mounds of marked-down polo shirts.

Call it another losing bet for Mickey Drexler. Long hailed as the merchant king whose inspired wager on khaki pants ignited a huge growth spurt in the late 1990s, Drexler recently has been on a ruinous losing streak. Gap's once-reliable growth engine has seized up: Sales at stores open at least a year plummeted by 17% in both August and September. As Drexler acknowledges, each of the company's three core brands—Gap, Banana Republic, and Old Navy—has come un-

tethered from the tight rapport with consumers that accounted for its earlier prosperity. Aggravating those tensions are the CEO's dogged insistence on adding new stores while trying to fix the fundamentals, plus management turnover, in particular last year's exodus of some seasoned executives who knew

when to rein in Drexler's impuls-

Now, many analysts and investors who long trusted that Drexler, 57, would once again pull a rabbit out of his hat, he did during a downturn in the mid-'90s, fear that he has lost his magic. Even in a tough retail environment, Gap's declining same-store sales are worse than

those of its peers, having fallen 11% so far this year after declining 5% in 2000. In contrast, Abercrombie & Fitch Co. is down 7%, while American Eagle Outfitters Inc.'s are 4.4%. Emme P. Bernstein & Co., expects Gap to lose \$216.6 million in the third quarter, including a charge of \$140 million to \$150 million related to adjustment in rates. That follows five consecutive quarters of declining profits. Says Kozlowski, "The Street has lied way too much to the 'Mickey will fix it' idea. It's amazing that people give it the benefit of doubt." Increasingly, however, they do. Gap's shares are trading around \$35 a share down from \$35 in May and slightly more than one-quarter of their high of \$110 in February, 2000.



A LESS ROBUST EMPIRE

Veering from basic to trendy styles cost Gap, Banana Republic, and Old Navy legions of customers

While some observers figure the nation's more sober mood could spur a shift from rhinestone-encrusted jeans and other novelties to more tried-and-true styles, Gap won't necessarily benefit. Its customers have been fleeing

unters, such as Kohl's and Target, youth-oriented chains, such as American Eagle, that offer similar s. "Somewhere along the line, Gap lost it," says New York retail consultant Wendy Liebmann. Drexler scoffs at that and refuses to concede that he doesn't get it anymore.

absolutely still such, talking to mers every day, ng at product y day, involved the creative sses," he says. so far, Gap l members and ompany's found- Fisher family nue to express upport. "I don't of a merchant r than Mickey," director Adrian Bellamy, chair- of Gucci Group. going through icult time, but I ve Mickey will the company to r days ahead." d member and e Computer Inc. Steven P. Jobs s there's no talk placing Drexler: question's not in the ballpark." t talk to some e legions of ex- ves who have Gap over the couple of years you get a dift assessment.

nessWeek spoke former execu- none of whom l be identified, painted a dis- ing picture of a ger whose short tion span and sive flip-flopping ost the compa- early in both s and strategic rs. Drexler's re-

style arguably didn't matter so during the flush times, when Gap afford the inefficiency and waste sudden changes of heart create. es, his guesses were more often than wrong. Old Navy, launched in soared to \$1 billion in sales in ive years on the strength of low-

cost, whimsical fashions aimed at teens and their parents.

Former execs say Drexler still insists, though, on running the chain in a hands-on style and relying to an alarming degree on gut decisions. Critics contend that the company "is too big to be run by an entrepreneurial, possessed



What Needs Fixing at Gap Inc.

STORE NAMES	2000 SALES (Billions)	STORES	KEY CHALLENGE
GAP DIVISION	\$7.4	2,759	Figure out whether it's a reliable purveyor of basics, a pipeline to new fashion trends, or both
BANANA REPUBLIC	1.6	422	Offer a better fashion mix, especially in menswear
OLD NAVY	4.6	732	Appeal to grownups again, not just teens, while maintaining an identity distinct from Gap stores

Data: Sanford C. Bernstein & Co., company reports, *BusinessWeek*

genius," as one alumnus puts it. It hasn't been unusual for Drexler to approve, say, gingham-check skirts for the Gap chain only to cool on them once they arrive from the factory, says a former manager. The skirts were shipped to Gap's outlet stores, forcing the regular stores to overemphasize core denim

styles to fill the void. "When you see the denim stretched out in the store and think it sure looks kind of basic, it means Mickey fell out of love with something," the exec says. Another recalls the time Drexler approved new store racks and shelves only to decide after they were installed that their overall appearance "just doesn't hit me." Store managers dragged out and reinstalled the old racks while Gap wrote off the new ones. "He'll pull the plug on things," says the former exec. "It's part of his emotional style." Gap dismisses such complaints, saying such changes are "part of the normal give and take of the business."

CONCRETE FLOORS? Some of the flip-flops have strained relations not just among Drexler's staff but also with external partners whose goodwill Gap needs to cultivate. Drexler created an internal uproar last summer when he greenlighted a change in design for new Gap stores without making sure that company real-estate specialists assigned



Given the chain's woes, analysts wonder why it's adding new stores

to negotiate with mall developers had been informed. The real estate team then had to go back to developers to persuade them to accept the new design, which uses concrete floors and open ceilings rather than the maple floors and finished ceilings that had been promised. Some developers were affronted, feeling the retailer was trying to put an eyesore in their malls. "It was a significant departure from what people expect from a Gap," says Leonard Richards, senior vice-president of Chicago mall developer Landau & Heyman, which is putting a Gap unit in a mall opening late this year in Carbondale, Ill. "It didn't look like a Gap. It looked like an outlet or an Old Navy." When Richards objected, Gap stayed with the original design. Calling the new look a test, Gap says: "We wouldn't force it on anyone."

Certainly, Drexler's not backing off his intrusive stance. Asked at a recent investors' conference whether he'll continue to devote so much time to minute details, he responded that "you become a bit more dictatorial in this kind of environment."

Of course, creative types often have disruptive personalities. Board member Jobs, no stranger to an impulsive management style, defends Drexler—who sits on Apple's board—on those

The Corporation

grounds. "I think Mickey Drexler is a creative person," Jobs says. "As a creative person, he's not a robot—he's a human being with moods. When he sees something he doesn't like, he says so." Drexler sees that as a requirement in an ever-changing industry. "I do like to introduce newness at the edges of the business all the time," he says. "That might be read as mercurial or inconsistent, but you can't get the new ideas without challenging current ideas."

To be sure, some of Drexler's staff find his style motivating. "Creative people really like working with him because he's emotional, passionate," says Amy Schoening, senior vice-president and chief marketing officer at Gap. She recalls Drexler's insistence two years ago that Banana Republic cast some older people in its catalog, over the objections of Schoening and her staff. Now, she concedes the "inclusive" move generated goodwill among those older customers. Dennis Connors, who left his post as Gap's chief information officer in 1999, adds: "People who blame Mickey, they have to grow up.... It's a fast-paced company. The cycle times for fashion are getting shorter and shorter."

REACHING OUT. Problem is, in the past, there were plenty of veteran managers and staffers around who could talk Drexler out of going too far out on a limb. Today, many of those veterans have left the company. Of the 23 corporate and divisional officers named in Gap's 1999 annual report, 8 have departed for various reasons, including 4 of the 5 officers in the Gap division. True, Drexler gets good marks for some of his replacements. That's particularly the case with nine-year board member John M. Lillie, who was put on the payroll in January as vice-chairman and assigned to such crucial matters as manufacturing and distribution systems and cost-cutting, none of them Drexler's forte. In recent months, Drexler has also filled key marketing and operating jobs at each of the chains while reaching outside the company for help. He also dropped his longstanding practice of creating all advertising in-house by recruiting Boston agency Modernista, which has helped Gap develop ads using offbeat celebrities, as the chain did with great success in the late 1980s.

Still, it may take a while for the new execs to decode Drexler—to "lip-read" him, as company insiders say. An edict to order 50,000 more shirts might be meant literally, or it could just be a metaphor for taking risks. "You have to figure out when he's serious and when he's emotionally going off," explains a former Gap exec. Meanwhile, staffers often end up playing guessing

games in which they debate what they think the CEO wants, says another former manager. And with some of the newcomers arriving from very different corporate cultures, the learning curve may be steep. "They all could potentially have what it takes to run their businesses, but do they have experience

in their positions? No," says Karen Hiatt, an analyst at Gap shareholder Dresdner RCM Global Investors.

With all three chains facing big problems, there's no time to waste. Banana Republic, which last year offered such flops as a line of purple clothing, is struggling to come up with a fashion mix that its 30-and-older customers, especially men, feel more comfortable wearing, Drexler says. Old Navy, whose merchandise mix last year skewed too far toward teens, is scrambling to win back grownups with a line of subdued slacks and jackets, sold as the Old Navy Collection. Old Navy also still struggles to restore a distinct identity to avoid drawing bargain-hunting Gap shoppers. Instead of chasing niches, Drexler feels Old Navy should claim higher terrain as a purveyor of "fun, fashion, and value for the whole family."

The biggest problem, though, is at the core Gap chain, which in its peak years appealed to everyone from teens to baby boomers with its huge se-

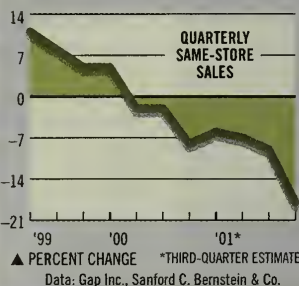
lection of khakis and wearable t-shirts. Drexler took a serious wrong turn in 1999, pushing Gap into fashions that were too young-looking for its client. Today, he has gotten rid of the odd-looking pink capri pants and cargo pants in favor of items with broader appeal that hopes reflect "casual style." But that emphasis still seems to span irreconcilable genres. Earlier this year, Drexler declared Gap's target market to be 20- to 30-year-olds who crave fashion. So for the fall season, he ditched much of the basic-style merchandise and took a gamble at offering trendier, more cutting-edge fashions, such as belted sweaters, super-dark denim jeans and handbags. That's a risky move that has Gap vulnerable in apparel's most treacherous segment: against more agile competitors, such as American Eagle, which can revamp its merchandise mix in half the time. Gap needs to respond to shifting tastes. Its plummeting same-store sales this

suggest that Drexler is off-base again.

With Lillie in place, Gap has finally committed to realistic cutting. One of Lillie's more dramatic moves was a first-ever layoff of 1,040 employees in July. Yet Drexler continued to increase the store count by 20% in both 1999 and 2000. He has backed off a bit on the pace of expansion—down to 10% for next year, to 5% to 7%—but some analysts wonder why he's expanding at all. Drexler insists there's still opportunity to be taken, but admits he's evaluating 2002 locations that haven't already been signed.

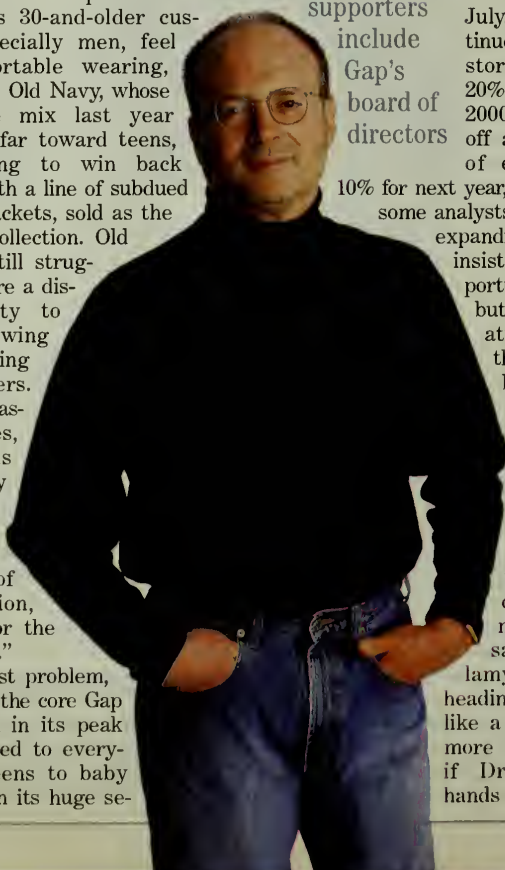
Drexler's supporters on the board say he's merely cutting the store base they set, all agreed to the foot on the accelerator for massive expansion, says director Larry Lam. But with heading for what looks like a wreck of a store, more investors would be if Drexler has his hands on the wheel.

FALLING INTO THE GAP



GAP

Drexler's supporters include Gap's board of directors



The loss we share is tempered
only by the memory of ordinary
men and women who did
extraordinary things
in a moment of great peril.

We celebrate the American Spirit
and all the no-limits men
and women who embody it.



LEAPs: Here's a Chance To Hop Over Risk

These equity contracts can offer a safer way to edge into the market

BY ANNE TERGESEN

With Wall Street brooding over war and recession, it's hard to make the case that a bull market is right around the corner. Instead of waiting on the sidelines—a risky move, since share prices often spike before most realize a recovery is under way—consider investing in Long-term Equity Anticipation Securities, better known as LEAPs. They're long-term options that allow you to bet on a stock's, or the entire market's, revival down the road in 2003 or 2004. "They let time work for you, which is important, since it will take time to recover," says Michael Schwartz, chief options strategist at CIBC Oppenheimer.

Sure, options are derivatives and can be risky when used to place big bets. But options can also be part of a low-risk investment strategy. For instance, with LEAPs, you can lock in today's beaten-down prices and profit from a rebound. If you're wrong, you stand to lose only a fraction of what you would have if you had purchased stock outright. Moreover, because options cost much less than their underlying shares, you can reduce the portion of your savings tied up in stocks, while maintaining the same level of exposure to the equity markets. Buying options can be "more conservative than owning a stock," says Kyle Graham, instructor at the Options Institute, the education arm of the Chicago Board Options Exchange.

LEAPs give you plenty of, well, options. You can trade them on about 340 stocks. Or you can use LEAPs to make plays on the popular market indexes, such as the Dow Jones industrial average, the Standard & Poor's 500-stock index, or the Nasdaq 100. Moreover, while prices on short-term options can jump sharply from day to day, LEAPs prices typically move gradually until about three months before expiration, when they behave like short-term options. LEAPs allow you to "weather some of the stock market's volatility without having to watch your positions constantly," says Joseph Sunderman, manager of research at Schaeffer's Investment

Research, an options firm based in Cincinnati.

Although these options have expiration dates you don't have to hold them until then. If after while it looks as if you were wrong about stock's prospects, you can sell the option. You won't make much—how much value remains depends on how far the stock has moved and how much time is left until expiration. But you likely recoup some of your losses.

Another advantage to LEAPs is their tax treatment. LEAPs generally offer two expiration dates with the current contracts lapsing in January 2003, and January, 2004. (The first group of 2 LEAPs is expected to appear in May, 2002.) Like short-term options, LEAPs held for a year

a day or longer should qualify for the lower capital-gains tax rate reserved for long-term investments, says Ryan, manager of the Options Industry Council Call Center, which

serves brokers and individual investors. However, if instead of selling your options you exercise them, you must hold onto the stock for another year before it can qualify for long-term capital gains tax treatment, Ryan adds. Since the rules can be complex, consult a tax expert.

As is the case with the more familiar short-term options, LEAPs come in two varieties—calls and puts. If you buy a call, you've got the right, but not the obligation, to purchase a stock at a specified price until an agreed-upon expiration date. Sell a call, and you may be asked to sell your stock at the pre-agreed price.

Puts are just the opposite. If you buy a put, you've got the right, but not obligation, to sell your shares at a specific price. If you sell a put, you've agreed to buy stock at a certain price from the owner of the put.

Which strategy makes sense for you depends on your outlook for a stock and the

Options

e-off between risk return that is ac- able to you. Web , such as that run by Chicago Board ions Exchange w.cboe.com), can help calculate potential rns. Options prices available there and at BusinessWeek ne (www.business- .com).

ou don't have to be avy hitter to trade ns. True, it's more omical to place big es, because broker- commissions are typ- 7 about \$20 for the contract and then ne sharply. But bro- ges often require those who buy LEAPS puts calls, or sell calls on stock they already own, ive an account worth at least \$5,000 and a worth of \$25,000.

hat follows is a description of how LEAPS can sed in strategies that reflect bullish, neutral, bearish outlooks on the market.

ING UP. One way to bet on a recovery in or 2004 is to buy LEAPS calls. Say you have eye on Cisco Systems. Instead of buying stock at its Oct. 15 price of about \$16, you purchase a LEAPS call that gives you the

Buying Calls

Cisco Systems is trading at \$16, and you think the stock will be above \$20 within the next 14 months. You can buy the stock outright. Or for \$5.10 you can buy a LEAPS call option that entitles you to purchase Cisco at \$15 by Jan. 18, 2003. (Each option contract covers 100 shares, so a \$5.10 premium requires an outlay of \$510.)

	STOCK PURCHASE	CALL PURCHASE
COST (100 SHARES)	\$1,600	\$510
STOCK GOES TO \$25	\$900 profit	\$490 profit
% GAIN	56.3%	96%
STOCK GOES TO \$10	\$600 loss	\$510 loss
% LOSS	37.5%	100%

to bet on the market while maintaining a safety net is to combine LEAPS calls with ultrasafe investments, such as money-market funds or U.S. Treasury bills. To see how this works, consider a woman who wants to buy 1,000 shares of Cisco at \$16. Rather than shell out \$16,000 for the stock, she can control the same 1,000 shares with 10 LEAPS call contracts, giving her the right to buy Cisco at \$15. Each contract costs \$510, so the total outlay is \$5,100.

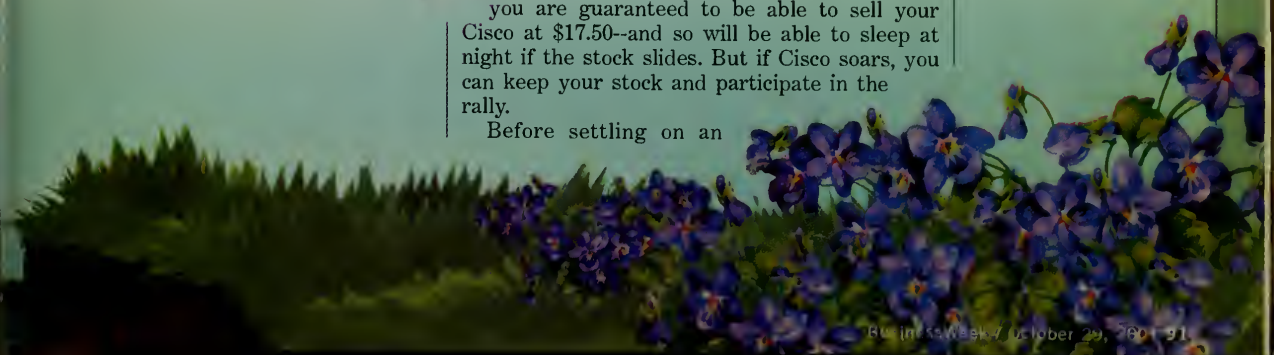
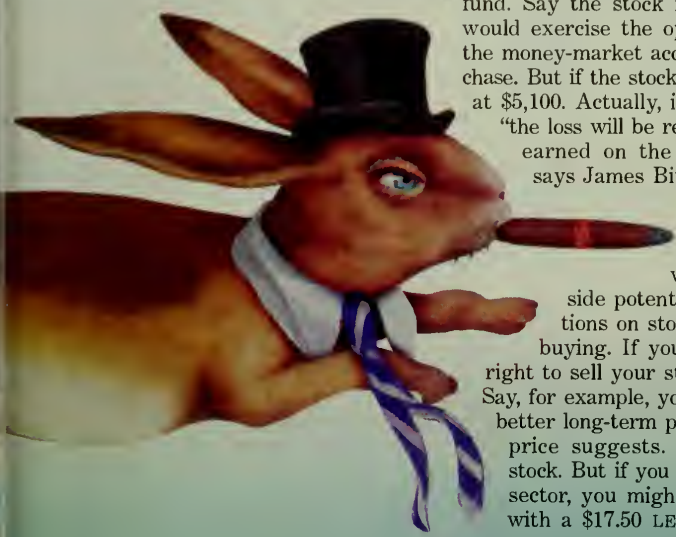
The woman can then deposit the remaining \$10,900 she wants to invest into a money-market fund. Say the stock rises to \$30. The investor would exercise the option to buy at \$15, using the money-market account to help fund the purchase. But if the stock falls, the losses are capped at \$5,100. Actually, it's a little bit less because "the loss will be reduced a bit by the interest earned on the money market account," says James Bittman, senior instructor at the Options Institute.

NERVOUS. Another way to gain some protection while preserving your upside potential is to buy LEAPS put options on stock you already own or are buying. If you buy a put, you have the right to sell your stock at a pre-agreed price. Say, for example, you think Cisco Systems has better long-term prospects than its \$16 share price suggests. You can always buy the stock. But if you are nervous about the tech sector, you might protect your investment with a \$17.50 LEAPS put. With this option, you are guaranteed to be able to sell your Cisco at \$17.50—and so will be able to sleep at night if the stock slides. But if Cisco soars, you can keep your stock and participate in the rally.

Before settling on an

right to buy Cisco at a specific price in the future. One frequently traded LEAPS call entitles its owner to buy Cisco at \$15 per share by January, 2003. On Oct. 15, the premium—or price—on that contract was \$5.10, which really means \$510, since each call option typically covers 100 shares. If Cisco rises—say, to \$25—you would buy the stock at \$15 and reap a profit by selling it at \$25. However, should Cisco fall below \$15, your losses are capped at the \$5.10 premium.

If you're a conservative investor, try combining LEAPS calls with ultrasafe financial tools, such as money-market funds or T-bills



Generally,
the more
protection an
option offers
on the downside,
the stingier
its payoff in a
rising market

expiration date or strike price, consider your outlook for the stock. For example, if you think Cisco will hit \$25 by January, 2003, why pay a hefty \$5 premium for an option that locks in a \$17.50 sale price? You'd be better off paying a smaller premium of \$3.50 for a \$15 sale price. Sure, you have less protection against a sell-off. But if Cisco rallies, the lower premium positions you to share in more of the profits. Generally, the more an option protects, the stingier its payoff in a rising market.

If you're particularly bearish on a stock, you can just buy the put without owning any shares. Say, for example, you pay \$5—actually \$500—for the right to sell 100 shares of Cisco at \$17.50. If the stock falls, the value of your put will rise—let's say, to \$5.50—as more investors chase after a guaranteed \$17.50 exit price. In this example,



Buying Puts

You bought Cisco Systems at \$16. You think it will rebound but are unsure about current market conditions. You can hold the stock. Or for \$3.50, you can buy a put option that gives you the right to sell your stock for \$15 by Jan. 18, 2003.

	HOLD THE STOCK	BUY A PUT
COST (100 SHARES)	\$1,600	\$1,950 (\$1,600 stock purchase price plus \$350 put price)
STOCK GOES TO \$25	\$900 profit	\$550 (\$900 profit from stock less \$350 spent for put)
% GAIN	56.3%	28.2%
STOCK GOES TO \$10	\$600 loss	\$450 loss (\$1,600 purchase price for the stock, plus \$350 price for the put, minus the \$1,500 sale price on the stock)
% LOSS	37.5%	23.0%

Selling Calls

You bought Cisco Systems at \$16 and believe the stock has some—but not much—upside potential over the next 14 months. You can sit tight and hold the stock. Or you can sell a LEAPs call option that allows another investor to buy your stock for \$15 by Jan. 18, 2003. That will net you \$5.

	HOLD THE STOCK	SELL A CALL
COST (100 SHARES)	\$1,600	\$1,100 (\$1,600 stock purchase offset by \$500 premium)
STOCK GOES TO \$25	\$900 profit	\$400 profit (\$500 premium minus \$100 loss when you sell the stock for \$15)
% GAIN	56.3%	36.4%
STOCK GOES TO \$10	\$600 loss	\$100 loss (\$600 loss is mostly offset by \$500 premium)
% LOSS	37.5%	9.1%

you can sell your put for an immediate profit of 50¢ a share. Of course, if the stock rises, your put will lose value. But your losses are capped at the \$500 you paid for the LEAPs.

Some traders use another tactic, known as a short sale, to bet on a downturn. Selling short involves selling borrowed shares today in the hope that when it comes time to replace them, the price will be lower. But that's more risky than buying puts because it leaves you exposed to unlimited losses if the stock soars.

TREADING WATER. If you expect a stock you own to tread water, a good way to make some money while holding it is to sell a call. Say you bought Cisco at \$16. If you sell a call giving someone the right to buy your stock at \$17.50 by January, 2003, you will immediately pocket a \$3.90 premium. Of course, if the stock rises above \$17.50, you will be forced to sell your shares at the bargain price of \$17.50. But that's not so bad, since you will realize a \$1.50 gain on the sale. And when combined with the \$3.90 premium, this gives you a 34% return on your \$12.10 investment. Cisco would have to rally to \$21.40 for you to receive the same return on a stock purchase.

If Cisco falls below \$17.50, no one will want to buy it at \$17.50. So the call will expire worthless, and you will keep your stock. Still, the call's premium gives you some protection. If Cisco could decline by as much as \$3.90 to \$12.10, from your \$16 purchase price—and you would not lose a dime.

Among the Cisco LEAPs calls with the highest trading volumes on Oct. 15 were those with strike prices of \$15, \$17.50, and \$20. Since the \$15 call is already valuable—who wouldn't want to buy a \$16 stock for \$15?—it will net you the highest premium. But if you sell this call, you run the greatest risk of being forced to sell your shares. So don't write calls on a stock unless you would not mind selling it at the agreed-upon price.

LEAPs require you to master a new set of rules and calculations beyond what it takes to invest in stocks. But they give conservative investors a tool to bet on a stock market recovery down the road—without betting the ranch. Even if that an economic recovery has been delayed by the events of September 11, you can't afford to ignore tools for placing long-term bets.

If your business solution can't get you there
Is it really a solution?



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The Way to Grow

If you own a fund

the law doesn't allow the funds to distribute them. Instead, they remain on the funds' books and can be used only to offset future gains.

Out of this inequity in the tax springs an opportunity. If you're vesting with taxable money—your IRA or 401(k) accounts—you should seek funds with good long-term records that have lots of ink on their books. That way, as the fund rises again, the portfolio manager can apply those accumulated losses to offset future gains. For instance, the \$380 million Pin Oak Aggressive Stock Fund has more than \$770 million in losses right now. As a result, manager James Oelschlag doesn't "expect to pay any capital gains for several years."

The bear market has left no shortage of red ink. According to Standard & Poor's, 2,568 of 3,363 equity funds—76.4%—now have accumulated losses. Those losses can act as shelters. How? Consider the Firsthand Technology Value Fund. According to its June 30 semiannual report, the fund had accumulated over \$2 billion in capital losses from the tech crash. Provided tech stocks recover—and this is one of the best investments in the sector—portfolio manager Kevin Landis will be able to run up \$2 billion in realized gains before he must make another distribution. (Such sheltering doesn't eliminate your tax liability if you happen to sell fund shares at a higher price than you purchased them.)

TECH, AGAIN. Of course, you don't want to buy a fund that's inappropriate for you just because it may shelter you from taxes. "There's no question that some people will be looking for funds for tax purposes," says Harold Evensky, a Coral Gables (Fla.) financial planner. "That could be a big mistake if they wind up in volatile sectors or funds with bad management. The key is to find a good fund that fits your overall portfolio."

The biggest losses are in the technology and telecom funds. So, one strategy would be to identify the best funds of the battered Dresdner RCM Global Technology, Fidelity Select Developing Communications, and Firsthand Technology Value all have losses at least as great as their assets (table). "Even in an optimistic market, it will probably take at least two or three years of gains to cover our losses," says Walter Price, portfolio manager of Dresdner RCM Global Technology.

Putting Mutual Fund Losses to Good Use

Strong funds swimming in red ink can be a good buy

BY LEWIS BRAHAM

When mutual funds sell appreciated stock, the law requires them to distribute their net capital gains to shareholders. Last year near this time, such payouts amounted to nearly 10% of the average equity fund's assets, the result of taking profits built up during the bull market. That rankled shareholders, who found themselves with huge tax liabilities even though their funds were falling in value. This year, most funds are swimming in losses, but



considerably less than what you paid, sell it and buy another

Some good diversified funds also have sizable losses. Harbor Capital Appreciation, Janus Mercury, and Van Kampen Emerging Growth, all badly in the bear market, are still highly valued growth funds and should do well when the sector revives. "The fund can rise about 10% from here without incurring any tax liability," says Janus Mercury manager Warren Lamont. With over \$5 billion in realized and unrealized losses, it's unlikely that new money invested in Mercury will dull its tax edge.

If you want to cast a wide net to find funds that have lots of tax-sheltering potential, it pays to subscribe to the premium service at Morningstar.com for \$99 a year. Go to the Morningstar Fund Selector. Under "Set Criteria," select "Tax Analysis," and set "Potential Capital Loss Exposure" to less than zero. Then select "Morningstar Ratings" and set "Category Rating" to greater than or equal to four. That ensures that the fund has losses on its books, yet is beating the risk-adjusted return of its peers in its fund category, be it large-cap growth, foreign stocks, technology or any other.

Don't stop there. Capital loss data are often outdated because funds are required to report them only twice a year. So you should make sure the funds have losses this year—not a problem in the current market. Select "Performance" and set "YTD Total Return" to less than zero. Negative returns mean the capital loss is probably larger than the last reported number. You want the fund to be large enough that an infusion of new money from investors doesn't substantially dilute the pool of losses. So select "Portfolio Stats," and set "Net Assets" to greater than \$100 million.

CODE. The type of loss is also important to analyze, as some are more effective shelters than others. The kind that Standard & Poor's and Morningstar report are unrealized losses, which is what a manager has held onto his losing position. That shields the funds from future gains by the losing positions. Yet if the manager sells his losers, he has a "realized loss." Realized losses can counteract gains anywhere in the portfolio for up to eight years after the sale. You can view his loss data in fund semiannual reports.

To view semiannual reports, scan the fund company's Web site first. If you can't find them there, go to www.freeEDGAR.com. At freeEDGAR.com, enter the fund company's name (such as Fidelity Investments) and look for the latest reports labeled "Notes to Financial Statements," which is the fund's statement of Assets and Liabilities, which is added to a corporate balance sheet. Occasionally, however, funds include it only in a footnote. Some companies will give you even more up-to-date information if you call. For instance, Vanguard's phone reps provide loss data as of the end of the prior month.

What if you already own one of these funds with tax losses? If your shares are worth less

than what you paid for them, sell them and buy another loss-laden fund with a similar investment style. This way you can claim the loss in your fund shares as a tax write-off, yet still remain invested in the same type of stocks. If you like the old fund, the tax code permits you to buy it back 31 days after the sale and still get the write-off. If you've owned the fund shares long enough to still have a profit, it might be better to hold your position—and even add new money to that fund.

These tax shelters will eventually dissipate as the market recovers. So if you're really investing for the long term, find a tax-efficient fund with big losses. (A tax-efficient fund is one that takes steps to minimize having to make capital-gains distributions.) That way, once the funds have run through their losses, they'll still be managed with after-tax returns in mind. Such funds include Vanguard Tax-Managed International or T. Rowe Price Tax-Efficient Multi-Cap Growth, which have accumulated losses.

Such losses are a sore point with longtime shareholders. For new investors, however, they can make a stock market recovery a little bit sweeter. ■

In Search of Shelter

FUND /SYMBOL	CAPITAL LOSSES*	5-YR. AVG. ANNUAL TOTAL RETURN**	NET ASSETS MILLIONS
PBHG TECHNOLOGY & COMM PBTCX	444%	1.8%	\$508
MONTGOMERY EMERGING MARKETS MNEMX	251	-11.4	151
PIN OAK AGGRESSIVE STOCK POGSX	203	4.9	380
PBHG SELECT EQUITY PBHEX	194	5.4	439
FIDELITY SELECT DEVELOPING COMM FSDCX	162	10.9	799
FIDELITY SELECT TECHNOLOGY FSPTX	135	13.2	1,906
FIRSTHAND TECHNOLOGY VALUE TVFQX	117	10.6	1,700
DRESDNER RCM GLOBAL TECH DGTNX	100	20.7	300
NORTHERN MID CAP GROWTH NOMCX	97	18.7***	305
STRONG ENTERPRISE SENTX	87	27.4***	321
PUTNAM INTERNATIONAL VOYAGER PNVAX	71	10.2	700
JANUS MERCURY JAMRX	70	12.6	7,500
VANGUARD GROWTH EQUITY VGEQX	68	7.7	626
T. ROWE PRICE MEDIA & TELECOM PRMTX	52	19.0	655
VAN KAMPEN EMERGING GROWTH ACEGX	52	12.6	5,516
RS DIVERSIFIED GROWTH RSDGX	46	19.3	537
DREYFUS EMERGING MARKETS DRFMX	46	0.6	215
HARBOR CAPITAL APPRECIATION HACAX	43	11.0	6,915
NORTHERN SELECT EQUITY NOEQX	34	13.2	364
ARTISAN INTERNATIONAL ARTIX	33	13.5	4,700

* Losses as a percentage of net assets

** Appreciation plus reinvestment of dividends and capital gains before taxes as of Oct. 15, 2001

*** Three-year return; fund too new for five-year return

Data: Morningstar Inc., fund companies

WOMEN & CO.: WILL CITI GET IT RIGHT?



BY TODDI GUTNER

hers@businessweek.com

Citigroup may be a latecomer in courting women investors, but it's showing there are advantages to having waited. Its new division, Women & Co., is rolling out a unique program of services in three cities this fall—and nationwide next year—that go way beyond investing. Citigroup developed the concept by “watching what others were doing and knowing we had to do something different,” says Lisa Caputo, president of Women & Co. and Hillary Clinton's press secretary from 1992 to 1996.

At last count, some two dozen companies were targeting the women's financial-services market. But most programs merely offer seminars and brochures to help with investing. Women & Co., by contrast, is a membership program aimed at women ages 25 to 54 with an income or investable assets of at least \$100,000. For an annual \$125 fee, members are entitled to a host of services—from asset-allocation advice to financial counseling for a bereaved spouse or partner—as well as discounts for such services as mortgage, insurance, child-care centers, nanny referrals, and nanny payroll-tax preparation (table). You sign up either through Women & Co.'s Web site (www.womenandco.com), by calling 888 679-9255, or through Citibank and Salomon Smith Barney branches that are participating in the pilot.

Members also can enjoy so-called appreciation benefits, such as the midsummer lunch I attended at Manhattan's Four Seasons restaurant for a handful of initial members. It featured Robert Rubin, former Treasury Secretary and chairman of Citigroup's executive committee, speaking on the global economy.

What's most refreshing is that members don't have to maintain a financial relationship with Citigroup to avail themselves of its services. Yet “I'm willing to bet members will be so pleased with the experience and the professionals” that they will transfer their assets to Citigroup, says Caputo.

Citigroup is hoping its investment advisers will come to serve as the linchpin of members' financial life. Women & Co.—which



CAPUTO: You don't have to have a Citi account

plans to have some 150 advisers from either Salomon Smith Barney or Citibank for the New York, Chicago, and Miami markets—says, an adviser approach will be heavy on education with clients given lots of time to make decisions. The idea grew out of nearly two years of focus groups and interviews with women who they wanted flexibility, options, and in formal when it came to financial services. To pick an adviser, members can log onto the Web site, which will list the planners and their credentials. Unfortunately, the group was training advisers at the time of this writing so I didn't experience the Women & Co. approach firsthand.

EASE OF USE. Citigroup also has tapped Aya Albany, N.Y., a financial-planning firm in which it has a 13% stake, to provide members with a toll-free telephone answer line, a robust online financial-planning tool, and a financial-counseling service for those who have lost a spouse or partner. Survivor-support services can range from helping you track down crucial documents to estate-planning advice.

I was impressed by the depth and ease of use of the online-planning tool, which you link through the Women & Co. site. It took me about 30 minutes to plug in all the data it requested. While some questions could be clearer, I was easily able to get help via the answer line. I didn't recommend specific investments, but I did assess my overall financial health, map out an asset-allocation plan, and specify the steps needed to reach my retirement goals.

Citigroup's concept of offering women a range of financial products and services under one umbrella has tremendous appeal. While some products, say, insurance or mortgages, can be found elsewhere for a lower price, Citigroup is betting that the convenience of having one place to go for financial advice will turn members into loyal customers.

A FULL-SERVICE CLUB

Citigroup's Women & Co. offers many services and discounts for its \$125 annual membership fee. Here's a sampling:

SERVICE	VALUE/SAVINGS
Toll-free financial advice answer line	\$500-\$1,000 a year
Financial counseling after loss of a spouse	\$3,000
Obtaining a mortgage over the phone	\$500 off closing costs or 0.25% off origination fee
Child care	10% discount at three national child-care centers
Nanny payroll-tax preparation	\$50 off registration fee
Online nanny-referral service	\$50 off registration fee

Data: Women & Co.

BusinessWeek online

To join a discussion in our forum, see hers.online.burke.com

ONE OF THE BEST WAYS TO PREDICT A PRE-OWNED VEHICLE'S FUTURE IS TO TAKE A LOOK AT ITS PAST.



Main Street Ford, Inc.

Vehicle Details:

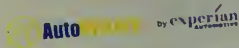
VIN: 1FALP59U1YA941524
Make: Ford
Model: Taurus SE
Year: 2000

Body: 4 Door Sedan 4-6 Passengers
Engine: 6- 182-EFI-3.0L
Assembled: United States

Auto History Events:

Last Reporting State/Province:	MI
Last Title Number:	901M1198154
Duplicate Title:	No
Last Date:	04/20/2000
Last Odometer:	10
Rollback:	No
Salvage:	No
Exceeds Mechanical Limits:	No
Failed Emission:	No
Not Actual Miles:	No
Damage:	No
Major Damage Incident:	No
Insurance Theft Claim:	No
Water Damage:	No
Lemon:	No
Odometer Independent Source:	No
Other Odometer Brand:	No

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DON'T BELIEVE EVERYTHING YOU READ



BY ROBERT BARKER

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Despite the endorsements of many financial heavy hitters, this new investment book fails to deliver on its promises

Talk about great expectations. A new book on investing is being endorsed by a veritable murderer's row of finance sluggers, from strategist Peter Bernstein and TIAA-CREF's resident rocket scientist, Martin Leibowitz, to that DiMaggio of money managers, Legg Mason's Bill Miller. Vanguard Group founder Jack Bogle even posted a five-star review at Amazon.com. These guys all agree that *Expectations Investing: Reading Stock Prices for Better Returns* is a home run. And I'm here to tell you it ain't.

It's not because the authors, Northwestern University emeritus professor Alfred Rappaport and Credit Suisse First Boston strategist Michael Mauboussin, are bums. Rappaport's 1986 book, *Creating Shareholder Value*, has wielded vast influence on corporate decision-making, while Mauboussin's distinctive essays on applying scientific esoterica to the market enjoy an avid following on Wall Street. But with *Expectations Investing* and its companion Web site (table), something went awry.

Rappaport and Mauboussin see most investors as hopelessly lost in their quest for mispriced stocks, since they rely on such crude tools as price-earnings ratios. We would do better, they say, focusing on free cash flow. Fair enough, even if this is the Street's worst-kept secret. Then they suggest a twist: Instead of forecasting a company's cash flow and using it to find a fair stock price, why not examine today's stock price to see what it implies about investor expectations? If the stock suggests expectations for unreasonably high cash flows, sell it. If expectations seem too low, it's a buy.

To show how to do this, the book studies computer maker Gateway in April, 2000, at \$52 a share. The math finds \$52 is justified only by making such assumptions as 20% annual sales growth and 9% operating margins through 2006. There's nothing "revolutionary," as the authors boast, about working backwards. It just reverses what thoughtful investors do all the time (and what you can do for free at www.valuepro.net). They also played out more bullish and bearish

scenarios, finding fair values from \$18 to \$76.

Yet no set of assumptions that they deem reasonable in April, 2000, proved right. Gateway trades today under \$6. Only those who foresaw shrinking sales and margins profited. The same old story: Working backward or forward, success rests on your assumptions.

The authors step into quicksand when they go beyond cash flow into something called "real-options value" analysis. Suppose cash-flow expectations do not justify a stock's price (think profitless Internet companies). Real-options analysis looks for extra value in a company's strategic options. Consider, as the authors did, Amazon.com in early 2000, at \$64 a share. Even with gener-

assumptions, cash-flow analysis valued Amazon at \$35. Could an extra \$29 be in "real options"?

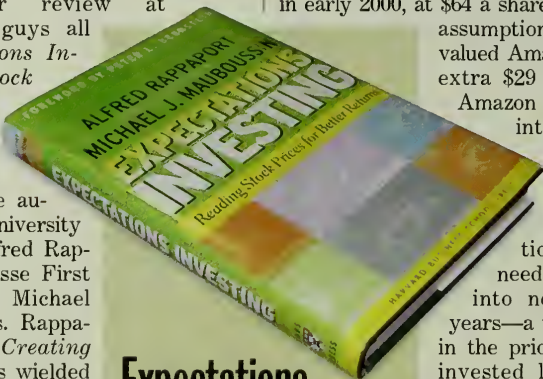
Amazon held to, say, expectations into other lines? Why not?

Lots of math, the book answers "no." To have exploited those imputed options, it says Amazon needed to put \$28 billion into new projects in the

years—a wacky prospect, since in the prior three years it invested less than \$2 billion. Amazon is now under \$9, any wisp of real-options value long gone. Yet the book promotes this as a great way to gauge hard-to-value stocks.

SNAKE OIL. For all its elegance, the real-options formula strikes me as an elixir for anyone bent on rationalizing a crazy stock price. Instead of a sharp valuation tool, it's a prescription snake oil. If humans are susceptible to hucksters promising arettes that "taste good," we're also capable of swallowing Amazon at \$64, along with dream it would be Earth's No. 1 stock. Who knows exactly where Amazon's superb stock promotion ended and its real-options value began? No one.

While *Expectations Investing* often falls into such consultantspeak as "the trigger," it has strong parts on evaluating merits and liabilities from employee stock options. Yet the book fails to deliver its promise of "the best available process to achieve superior returns." For investors, it notes, win by foreseeing change in expectations. So if endorsements of this book prompt you to buy it, first take your expectations and revise them down, way down.



Expectations Investing

COVER PRICE \$29.95

PUBLISHER Harvard Business School Press

WEB SITE www.expectationsinvesting.com

BEST PART The Web site's interactive spreadsheets

WORST PART Gobbledygook such as: "The powerful combination of the expectations infrastructure and competitive strategy analysis highlights the economic and strategic factors that influence the operating value drivers."

BusinessWeek online

For barker.online, go to www.businessweek.com/investor/ and click on "Column"

*We the People of the United States, in Order to
form a more perfect Union, insure domestic Tranquility, provide
for the common defence, promote the general Welfare, and secure the
Blessings of Liberty to ourselves and our Posterity, do ordain and
establish this Constitution for the United States of America.*

-United States Constitution

Our thoughts and sympathy go out to all the men, women and their families
who were directly affected by the tragic events that occurred on September 11th.

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their lives and businesses back in working order.



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OR: BIOTECH BAIT?



GENE G. MARCIAL

Therapeutics' its may spark takeover. Mikohn could fall to an Aussie machine rival. ing La Quinta pruced up— how to buyers?

Is COR Therapeutics (COR) buyout-bound? As with other biotechs, shares of COR, a highflier last year, have dropped precipitously. The stock fell from 43 early this year to 18 on Oct. 8, before edging up to 20 on Oct. 17. Never mind that COR has started making money on its chief product, Integrilin, an anti-clotting drug for heart patients. This is one reason some analysts have remained bullish—despite COR's warning on Oct. 3 that sales for the third quarter and all of 2001 would fall below estimates—a result of the general post-September 11 downturn.

Analyst Mark Monane of New York investment firm Needham—who rates the stock a buy, with a 12-month price target of 42—terms the sales drop a “hiccup.” He expects “dramatically higher” Integrilin sales in the fourth quarter and 2001 total sales of more than \$240 million, up from last year's \$104 million. Integrilin, which Schering-Plough also markets, has a market share of 51%. Monane figures COR will earn 30¢ a share in 2001 and 93¢ in 2002.

John McCamant, editor of the *Medical Technology Stock Letter*, views any weakness in the stock as an “attractive buying opportunity.” He thinks COR is a potential takeover target because of the sharp drop in the stock and the huge potential of Integrilin and other products still in clinical trials, such as Cromafiban, an oral form of Integrilin. “COR has all the right stuff for the likes of a Pfizer or Genentech to want to buy it,” says McCamant. He says CEO Vaughn Kailian is intent on building COR into a leading biotech, “but I don't doubt that several big drugmakers are eyeing COR” as a possible target. “In tough markets, selling becomes an important option,” says McCamant. At the right price, he says, “Vaughn might get tempted” to do a deal. COR is “well worth north of 40 in a buyout,” says McCamant.

MIKOHN'S BIG PAYOUT COULD BE A BUYOUT

In Las Vegas, slot-machine makers are on a roll: Stocks have rebounded sharply from mid-September lows. But one laggard is Mikohn Gaming (MIKN), which has developed an innovative line of slot machines based on board games such as Battleship, Yahtzee, Clue, and Trivial Pursuit. Its shares haven't joined the rally mainly because it has had little Street following. “Mikohn may be the best value in the entire group,” says one Califor-

nia hedge-fund manager, who has been snapping up shares, currently trading at 5, down from a high of 8.50 in early July.

One other reason he is accumulating shares: Mikohn, which has 2,600 slot machines that it leases to casinos, is a potential takeover target in a consolidating industry. This pro notes that Australia's top slot maker, Aristocrat Leisure, has a mere 3% market share in the U.S.—and has said it hopes to hit 20%. So far, Aristocrat has bought two small U.S. gambling machine makers this year. Mikohn, which expects to lease out an additional 1,200 machines to casinos this year, is a “logical acquisition” for Aristocrat, says the fund manager.

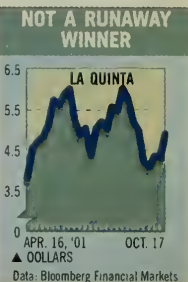
“Mikohn has provided some of the most compelling gaming products and equipment around the world since 1987,” says David Bain at Roth Capital Partners, who rates the stock a buy. He expects the company to earn 59¢ a share this year on projected sales of \$100.8 million, and \$1.41 in 2002 on sales of \$111.2 million.

LA QUINTA'S TIDY-UP MAY MEAN A SELL-OFF

Two things grabbed the attention of La Quinta (LQI) investors on Oct. 16, when the lodging company surprised them with news of a corporate restructuring: The Bass family of Fort Worth has held on to its nearly 10% stake in La Quinta, and the company will repurchase up to \$20 million worth of stock.

The fact that the Bases haven't unloaded shares—even though they recently sold most of their stake in Walt Disney to meet margin calls—suggests to some pros that the family thinks La Quinta is way undervalued and that it expects to reap huge profits, either through the sale of the entire company or some of its assets. And the stock repurchase signals that management, on the advice of the Bases, may be trying to make La Quinta more attractive as a buyout candidate for other companies, such as Cendant, whose appetite for hotel chains with a brand name is yet to be satisfied.

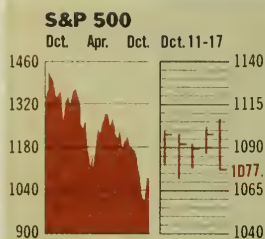
Seth Hamot of Costa Bravo Partners, which owns La Quinta shares, says the company's assets are worth \$2.5 billion. He figures that a fair value for La Quinta in a buyout is 13 a share. He agrees that Cendant would be the most logical buyer of La Quinta—in large part because of its own hotel properties and the stock's currently depressed price of 4.96 a share.



BusinessWeek online

Read Gene Marcial's Inside Wall Street Online column Tuesday afternoons at www.businessweek.com/today.htm. And see him Fridays at 1:10 p.m. EST on CNNfn's *The Money Gang*.

Stocks



COMMENTARY

The equity markets ended the week on an ominous note as stocks fell on concerns that the anthrax scare will further disrupt an already weak U.S. economy. On Oct. 17, the Nasdaq Composite fell 75.7 points, while the Dow Jones Industrials and S&P 500 dropped 151.3 and 20.5 respectively. Adding to the unease were weak earnings from AOL Time Warner and EMC.

Data: Bloomberg Financial Markets
Bridge Information Systems, Inc.

U.S. MARKETS

	Oct. 17	Week	Year to date	Last 12 months
S&P 500	1077.1	-0.4	-18.4	-20.2
Dow Jones Industrials	9233.0	-0.1	-14.4	-8.5
Nasdaq Composite	1646.3	1.2	-33.4	-48.8
S&P MidCap 400	447.3	-0.5	-13.5	-9.3
S&P SmallCap 600	201.3	0.2	-8.3	0.2
Wilshire 5000	9916.3	-0.2	-18.6	-21.2

SECTORS

	Oct. 17	Week	Year to date	Last 12 months
BusinessWeek 50*	720.4	-1.2	-25.7	-32.4
BusinessWeek Info Tech 100**	367.2	0.4	-35.1	-52.9
S&P/BARRA Growth	548.7	-0.5	-20.2	-29.2
S&P/BARRA Value	528.6	-0.2	-16.9	-10.8
S&P Energy	833.2	-2.2	-10.6	-10.7
S&P Financials	138.5	1.4	-15.9	-4.7
S&P REIT	90.1	-0.3	2.4	10.1
S&P Transportation	582.3	-2.8	-16.5	1.0
S&P Utilities	266.1	0.1	-24.1	-18.9
GST Internet	86.3	5.2	-52.5	-72.2
PSE Technology	578.3	2.0	-29.0	-37.1

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Insurance Brokers	19.7	Engineering & Constr. 90.2
Multiline Insurers	17.6	Toys 61.4
Genl. Merchandise Chains	16.2	Tobacco 57.3
Leisure Time	15.1	Pollution Control 49.2
Communications Equip.	15.0	Gold Mining 47.4

EQUITY FUND CATEGORIES

4-week total return %	52-week total return %
Leaders	Leaders
Technology 11.8	Precious Metals 30.3
Health 10.5	Real Estate 13.8
Large-cap Growth 9.3	Small-cap Value 13.1
Mid-cap Growth 8.3	Mid-cap Value 11.5
Laggards	Laggards
Precious Metals -0.9	Technology -55.8
Real Estate 1.2	Communications -50.3
Utilities 1.4	Japan -37.6
Latin America 2.4	Mid-cap Growth -34.1

EQUITY FUNDS

4-week total return %	52-week total return %
Leaders	Leaders
ProFunds UltraOTC Inv. 540.7	ProFunds UltraBull Inv. 193.8
ProFunds UltraBull Inv. 458.6	Potomac Internet Short 110.9
Conseco Science & Tech. A 26.6	Rydex Dynamic Vent. 100 84.9
World GenomicsFund.com 23.5	Schroder Ultra 81.8
Laggards	Laggards
Rydex Dynamic Vent. 100 -28.8	Berkshire Focus -85.3
ProFunds UltraShort DTC -28.7	Berkshire Technology -85.3
Potomac Internet Short -21.5	Merrill Lynch Focus 20 B -82.9
Dppenheimer Real Asset A -14.6	Van Wagoner Post Venture -82.1

Data: Standard & Poor's

GLOBAL MARKETS

	Oct. 17	Week	Year to date
S&P Euro Plus (U.S. Dollar)	1017.7	1.0	-2.0
London (FT-SE 100)	5203.4	1.0	-1.0
Paris (CAC 40)	4411.5	2.1	-2.0
Frankfurt (DAX)	4644.8	0.7	-2.0
Tokyo (NIKKEI 225)	10,755.5	7.9	-2.0
Hong Kong (Hang Seng)	10,260.8	-0.4	-3.0
Toronto (TSE 300)	6956.8	0.1	-2.0
Mexico City (IPC)	5541.9	-2.5	-1.0

FUNDAMENTALS

	Oct. 16	Wk. ago
S&P 500 Dividend Yield	1.42%	1.47%
S&P 500 P/E Ratio (Trailing 12 mos.)	36.1	34.9
S&P 500 P/E Ratio (Next 12 mos.)*	20.6	19.7
First Call Earnings Surprise*	1.89%	0.09%

*First Call Corp.

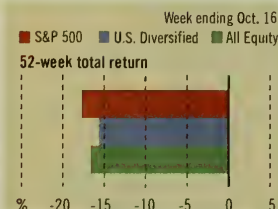
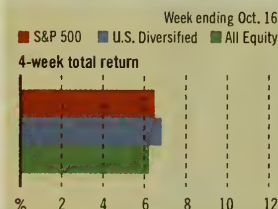
TECHNICAL INDICATORS

	Oct. 16	Wk. ago
S&P 500 200-day average	1214.8	1219.8
Stocks above 200-day average	41.0%	35.0%
Options: Put/call ratio	0.65	0.73
Insiders: Vickers Sell/buy ratio	1.92	2.59

WORST-PERFORMING GROUPS

	Last month %
Conglomerates	-18.4
Photography/Imaging	-16.0
Metals	-10.8
Savings & Loans	-10.9
Office Equip. & Supplies	-10.6

Mutual Funds



Data: Standard & Poor's

Interest Rates

KEY RATES	Oct. 17	Week ago
MONEY MARKET FUNDS	2.74%	2.84%
90-DAY TREASURY BILLS	2.21	2.21
2-YEAR TREASURY NOTES	2.77	2.76
10-YEAR TREASURY NOTES	4.57	4.60
30-YEAR TREASURY BONDS	5.31	5.36
30-YEAR FIXED MORTGAGE†	6.57	6.55

†BancQuote, Inc.

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt bonds, assuming a 31% federal tax rate.

	10-yr. bond
GENERAL OBLIGATIONS	4.00%
TAXABLE EQUIVALENT	5.80
INSURED REVENUE BONDS	4.22
TAXABLE EQUIVALENT	6.12

THE WEEK AHEAD

LEADING INDICATORS Monday, Oct. 22, 10 a.m. EDT ▶ The Conference Board's composite index of leading indicators likely fell 0.4% in September. That's based on the median forecast of economists surveyed by Standard & Poor's MMS, a division of The McGraw-Hill Companies.

FEDERAL BUDGET Monday, Oct. 22, 2:00 p.m. EDT ▶ The U.S. Treasury will probably report a September surplus of \$29 billion, after registering a deficit of \$80 billion in August.

BEIGE BOOK Wednesday, Oct. 24, 2 p.m. EDT ▶ The Federal Reserve Bank will release its compilation of regional economic activity in advance of the policy meeting scheduled for Nov. 6.

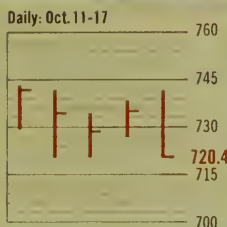
EMPLOYMENT COST INDEX Thursday, Oct. 25, 8:30 a.m. EDT ▶ Compensation in the third quarter likely rose by 0.9%, after a 0.9% gain in the second quarter.

DURABLE GOODS ORDERS Thursday, Oct. 25, 8:30 a.m. EDT ▶ New orders for durable

goods probably dropped 1% in September, after falling 0.3% in August.

EXISTING HOME SALES Thursday, Oct. 10 a.m. EDT ▶ Sales of existing homes are forecast to have dropped to an annual rate of 5.23 million in September, from 5.5 million in August.

NEW RESIDENTIAL SALES Friday, Sep. 10 a.m. EDT ▶ New single-family sales likely fell to an annual rate of 883,000 during September.

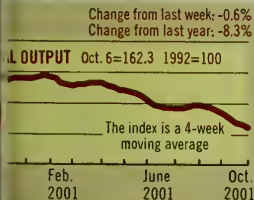


ended the week down 1.2% as weak earnings reports began piling up. Provident Financial fell 74% in a little more than six months. Financials such as Citigroup, Merrill Lynch, and Lehman provided small pockets of strength. Semiconductor manufacturer Texas Instruments rose 4.8%, on hopes the chip market may be bottoming.

COMPANY PERFORMANCE

Category	% change		Rank	Company	% change	
	Week	Since 3/1/01			Week	Since 3/1/01
Airline	3.1	-11.5	26	Verizon Communications	-2.7	8.7
Petroleum	0.7	-12.7	27	Citigroup	5.1	-4.3
	0.7	-39.9	28	Sun Microsystems	-3.2	-56.1
	4.3	-5.5	29	Merck	0.8	-13.4
Materials	-0.8	-29.1	30	El Paso	0.2	-25.6
Financial	-35.1	-74.0	31	Altera	-7.6	-23.8
Oil & Petroleum	-1.7	8.1	32	Marsh & McLennan	-0.5	-2.8
	0.5	-17.8	33	Household International	-1.8	-2.1
Technology	1.1	-13.0	34	ChevronTexaco	-4.7	2.6
	-4.4	-36.1	35	SBC Communications	-8.0	-5.1
Procter & Gamble	1.7	-10.9	36	Mercury Interactive	-15.0	-61.1
	-8.6	-73.9	37	AOL Time Warner	-4.7	-30.0
	4.1	-73.7	38	Washington Mutual	-7.1	-2.0
Pharmaceuticals	-3.3	10.6	39	General Dynamics	-6.9	24.8
Banking	0.9	-19.2	40	Comcast	-0.7	-16.4
Technology	-2.7	-42.5	41	Morgan Stanley Dean Witter	3.8	-17.4
	-6.4	-33.8	42	Tellabs	0.0	-69.9
Health	-1.3	-8.2	43	Exxon Mobil	-2.0	1.8
Energy	2.4	-3.8	44	Scientific Atlanta	-2.4	-61.7
Communications	7.8	-57.6	45	U.S. Bancorp	0.2	-23.1
Banking	-0.2	-14.2	46	Paychex	-3.0	-18.5
Petroleum	-0.9	6.4	47	Merrill Lynch	3.7	-26.3
Services	0.8	-3.5	48	Bed Bath & Beyond	0.3	8.6
Resources	0.0	-22.1	49	Texas Instruments	4.8	-7.7
Health	0.1	11.3	50	Teradyne	-7.0	-31.5

Production Index



The index continued its downward slide last week. Before calculation of the four-week average, the index dropped to 161.3, from 161.9 the previous week. On a seasonally adjusted basis, electric power, autos, and truck assemblies were all lower. The index was virtually unchanged. Rail-truck was primarily to a large increase in grain. The index was primarily to a large increase in grain. The index was primarily to a large increase in grain.

For more information on the index components is at www.businessweek.com.
Production index Copyright 2000 by The McGraw-Hill Companies

Online Resources

BW 50 Track the index and the companies in it all day long. Plus: our exclusive Info Tech 100 index.

BUSINESSWEEK INVESTING Real-time market coverage and investment tools in partnership with Standard & Poor's.

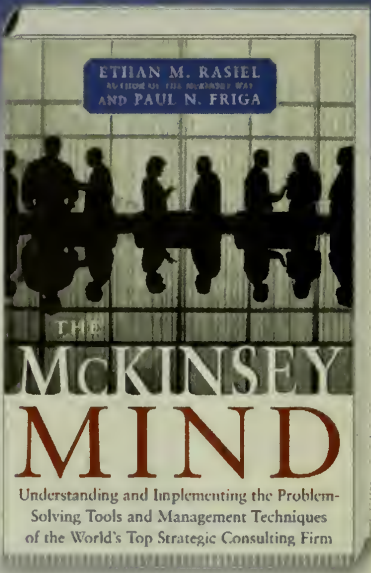
MUTUAL FUNDS Search for funds, view BW ratings, and read Q&A's with fund managers.

COLUMNS Hot stocks, takeover plays, and the latest strategies for managing your money.

BusinessWeek online

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U.S.-SAUDI RELATIONS: CHANGES ARE OVERDUE

The United States enjoys a handful of "special relationships" around the world, associations that go far beyond normal bilateral ties. Britain, Israel, and Taiwan come to mind. But few are as long-standing and as unusual as the seven-decade-old special relationship between America and Saudi Arabia. Since 1932, when Standard Oil of California paid the impoverished founder of Saudi Arabia 35,000 pounds in gold sovereigns for an exclusive 50-year oil concession, the U.S. has been in tight alliance with the Al Saud family dynasty. SOCAL found oil in 1938, a discovery that handed to the U.S. "the greatest commercial prize in the history of the planet," as one State Dept. envoy put it. Generations of Saudis would be educated in American universities. And Saudi petrodollars would help to finance the fight against communism, from Nicaragua to Soviet-occupied Afghanistan.

The depth and longevity of that relationship is now causing Americans to feel profoundly hurt, even betrayed, by the Al Sauds in the aftermath of terror attacks on September 11 (page 34). Americans are discovering that many of the terrorists were Saudi and that Osama bin Laden, himself a Saudi, is being largely financed with Saudi money. The Al Sauds may have torn up Osama bin Laden's Saudi passport in 1994, but they have been less than cooperative with the FBI in its anti-terror investigations. They have clearly done little to rein in Islamic charities funding the Al Qaeda net-

work. And one of the Al Sauds' most U.S.-oriented scion, Prince Alwaleed bin Talal, appeared to legitimize the terrorist attack on the World Trade Center by attacking American Middle East policy. His \$10 million "humanitarian" donation to New York Mayor Rudy Giuliani was roundly and rightly rejected.

What must the U.S. do now? It should throw its weight behind the efforts of 77-year-old Crown Prince Abdullah to root out widespread royal family corruption. Tens of billions of dollars that should have gone into stimulating economic growth and jobs have been siphoned off and wasted by absolute Al Saud family members. The U.S. should privately demand that Abdullah and the top five senior Al Saud princes formally and publicly disassociate the regime from Osama bin Laden's Al-Qaeda terrorist network and other Islamic extremist movements. Above all, Washington should encourage Saudi Arabia to open up its almost hermetically closed society, in the first instance, radically reforming an educational system utterly dominated by religious instruction. Saudi youth, almost half the population is under the age of 18, desperately need the skills and knowledge to find a place for themselves in a modern, interconnected world.

The U.S. and the Al Saud family go back a long way; this relationship is to continue to the benefit of both nations, a great deal has to change.

AN OPPORTUNITY TO REDUCE OPEC'S ROLE

Any discussion about U.S.-Saudi relations quickly gets to the subject of oil. Washington is awash in ideas about cutting U.S. reliance on OPEC oil. First the facts. The U.S. has already done a decent job in cutting its dependence on OPEC oil. In 1960, 81.3% of all imported oil came from OPEC. In 1990, it was 60%. By 2000, only 50.9% came from OPEC, and that figure continues to trend downward sharply. The U.S. has also succeeded in weaning itself off oil in generating electricity. Today, domestically produced natural gas, coal, hydroelectric power, and nuclear power provide practically all the electricity in the nation. Oil is used mostly for transportation, as well as petrochemicals and heating homes, mainly in the Northeast.

Conservatives are demanding more drilling and more oil supply. Certainly, a portion of that should now come from within the U.S., but the fastest way to boost production may lie in helping America's old nemesis and new geopolitical friend, Russia. Russia is already the second-largest oil producer, exporting 3 million barrels a day, compared with 8 million for Saudi Arabia. With just a small capital investment, it has already boosted production by 1 million barrels a day, to 7 million. With assistance, it could probably increase production to 11 million barrels, its peak in the 1980s, with most going for export.

The new U.S.-Russian anti-terrorist alliance can also help

boost production in the Caspian Sea region. This area has the largest oil field found anywhere over the past 30 years, and Washington and Moscow have battled fiercely over pipeline routes to get the oil out. With Russia, Uzbekistan, and other Central Asian countries joining with the U.S. against Taliban, that geopolitical competition is over. Millions of barrels could be pouring out of the Caspian Sea in two to three years. Together with large projects in Brazil, off the coast of West Africa, and in the Gulf of Mexico, the supply of non-OPEC oil is due to surge. That could permit the U.S. to significantly cut its dependence on OPEC oil in short order.

But it's not enough. To cut dependency, Detroit must do its part. Cars and light trucks (SUVs) are the main users of oil in the U.S. Existing technology today could nearly double mileage for autos. Washington, as a matter of national security, now should tell Detroit to raise its mileage standards. And providing tax credits to consumers who purchase high-mileage vehicles is one tax break worthy of consideration.

It may never be possible for the U.S. to be totally independent of OPEC oil. But encouraging production, especially overseas, while boosting engine efficiency at home could give the country a lot more freedom and maneuverability in years ahead.



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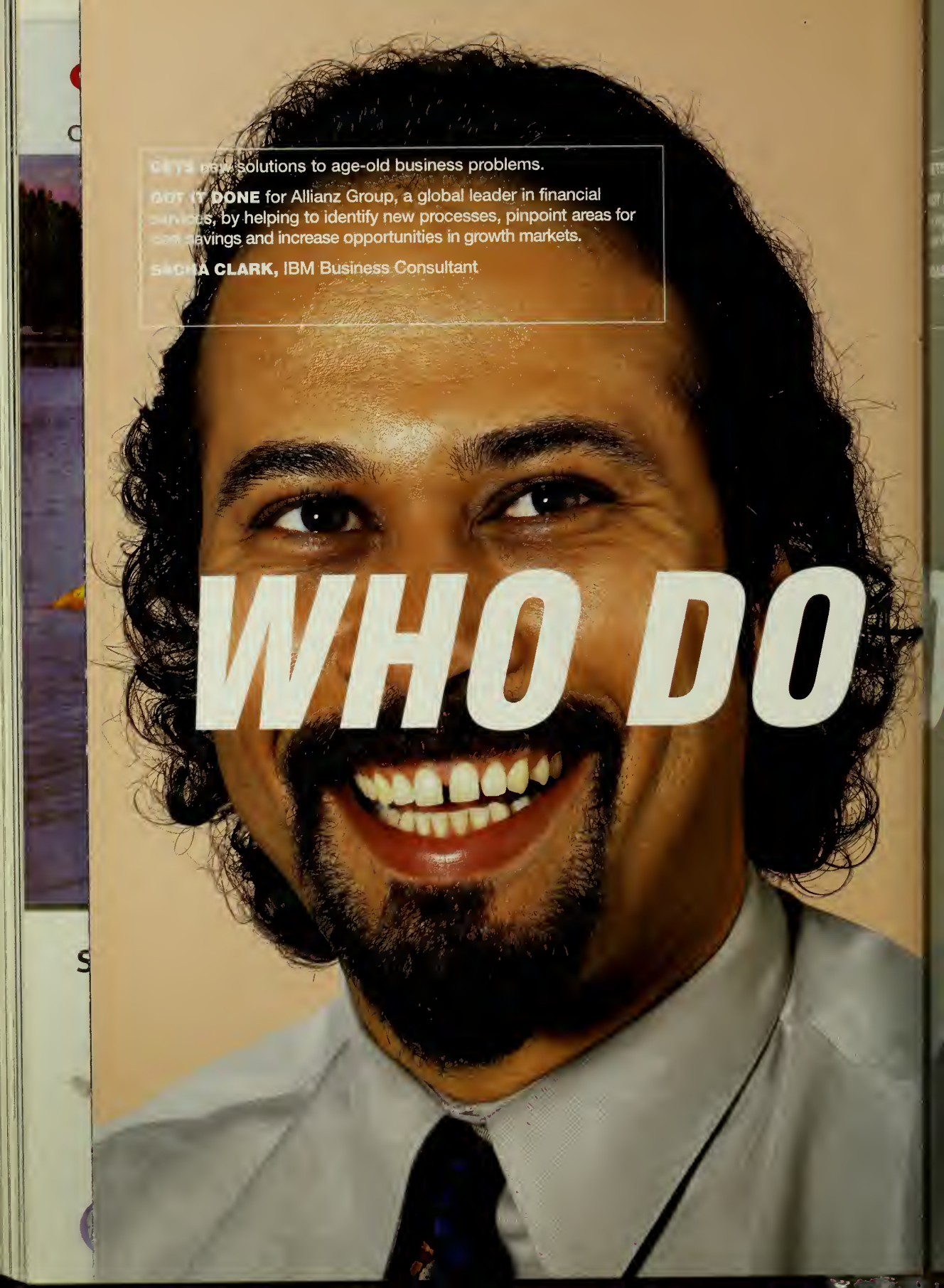


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We're Still Here!

Mark Twain appears to be alive and working the Web—in the form of e-tailer Buy.com Inc. Claiming rumors of its death are greatly exaggerated, Buy.com launched a “Not Going Out of Business Sale” on Oct. 1. “We were concerned customers weren’t aware Buy.com still existed,” says Stew Duncan, managing director of Thinkbig Marketing Group, Buy.com’s ad agency.

Will this latest gasp for attention work better than Buy.com’s 1999 TV ads featuring a man sniffing a dog’s rear end? Analysts wonder why Buy.com, having abandoned its original strategy of selling electronics below cost, would think it could price-cut its way to profits. The startup lost \$51 million in the first half of 2001.

“Low prices mean low margins,” says Jupiter Media Metrix Inc. analyst Ken Cassar.

Founder Scott A. Blum says he can do better, and made a still-pending offer in August to buy the 56% of Buy.com he doesn’t own for 17¢ a share. Shareholders, who have seen their stock fall from \$35 since February, 2000, might get more consolation from Twain’s fictional hero Huck Finn: Being rich ain’t what it’s cracked up to be.

— Arlene Weintraub



Calling All Wannabes

To get to Carnegie Hall, the drill has always been, practice, practice, practice. But Lori Weintraub says if your dream is Madison Square Garden, the next thing to do is log on.

The ex-Time Warner AudioBooks exec is president of InsideSessions.com, a distance-learning site set for launch on Oct. 17. InsideSessions says it can help anyone with \$49.95 and rock ‘n’ roll dreams. The theory is that people will pay for a class that offers five hours of video tutelage from the likes of rapper Shaggy or rocker Sting. The latter, for example, waxes on about how The Police shared hotel beds to save money before hitting it big. Budding writers’ classes feature authors Kurt Vonnegut and Doris Kearns Goodwin. “We think there is a great market out there for folks who want to break into the business and need the first step,” Weintraub says.

The idea hatched when Universal CEO Doug Morris and Penguin chief Phyllis Grann considered co-teaching a course at Columbia University—but decided to take their act online instead. Weintraub won’t say how much the two companies invested in the site. InsideSessions says graduates will get their demo tapes or manuscripts reviewed for their fee. Hollywood insiders point out a problem: You can’t teach talent. Just ask Milli Vanilli.

— Ronald Grover

What’s in a Name?

Web stocks were so popular that in early 1999 former U.S. Treasury Secretary Lawrence Summers joked that Brazil could fix a currency crisis by dubbing its currency, the real, Real.com. Now, Web companies are shedding their dot-com names—though it’s not helping much.

Old Name:	InfoSpace.com Inc.	Autobyte.com Inc.	DrKoop.com Inc.	GoTo.com Inc.
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Date Changed:	Mar. 2, 2000	April 11, 2001	Aug. 30, 2001	Sept. 10, 2001
*Stock Price: (old name)	\$119.00	\$1.49	\$0.12	\$14.95
**Stock Price: (new name)	\$1.78	\$1.00	\$0.08	\$18.59

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BY ELLEN NEUBORNE

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Break It to Them Quickly

Online shoppers who know shipping charges up front are less likely to bail out

E-tailer 1-800-flowers.com taught me it's possible to love shipping charges. That was no easy task. Like most Internet shoppers, I had come to view shipping and handling fees as the great rip-off of online merchants. But that changed when I met Delivery Wizard at the gift-and-flower site. Delivery Wizard is an online calculator that appears on the screen early in the shopping process (way before checkout)

and allows you to preview potential shipping charges. I can scan shipping-charge options as I peruse the floral selection and decide which combination suits my purposes and budget. Delivery Wizard removes the "Gotcha!" factor of shipping charges that leap onto the bill at the very last click of an online transaction. I still pay for shipping, but I'm not fuming while I do it.

That's the kind of consumer-centric approach that is going to have to take hold in e-tailing if merchants are going to overcome the shipping backlash. Delivery charges are the No. 1 reason shoppers abandon a virtual shopping cart, according to Jupiter Media Metrix. Every Internet shopper has a shipping-charge horror story. My best friend, while shopping for party favors for her 3-year-old's birthday bash, was stunned when she got to the end of the transaction and was greeted with a \$10 delivery charge on a \$30 order. "I'm buying goodie bags and paper noisemakers," she told me. "For \$10, I'll drive to the store." And she did.

E-tailers have no one but themselves to blame. It was the Internet retailing community's bright idea to lure us online with free shipping in the first place. Bad move. Like letting a kid eat ice cream for breakfast, it set a bad precedent, and it's tough to break. Once we got it into our heads that shipping ought to be free, any charge has smacked of gouging. "Online retailers made us feel like charging for shipping was at their discretion," says senior analyst Ken Cassar of Jupiter Research. Instead, he says, paying the cost of getting the package to your door is a crucial element for any online retailer. Without a way to cover shipping costs, an online merchant is doomed, he says. "When free shipping ended, consumers felt they were being taken advantage of—that the merchant was just making money."

Actually, charging for shipping is probably the only way virtual retailers will survive. But to get shoppers on board, e-tailers will have to be disciplined and creative in their approach. Jupiter recommends the industry move to standardized rates—something that is sorely lacking now. Today, e-tailers use a wide swath of measurements. Some charge by order value, some by the number of items, some by weight, and some by a combination of these factors. This confuses consumers, and it perpetuates the idea that e-tailers are making the whole thing up as they go. E-tailers ought to move to weight-based calculation, says Cassar. It's a standard anyone who has ever mailed a package from the U.S.

Post Office is familiar with, he says: "It doesn't take a lot of explaining, and if it were standard in the industry, consumers would feel more comfortable."

Good idea, though e-tailers shouldn't stop there. Merchants that create ways to make shipping less burdensome are seeing rewards. Thanks to Delivery Wizard, 1-800-flowers.com has seen the number of delivery-related customer service calls drop from 100 a day to "near zero," says President Chris McCann. Sears.com will roll out a program later this fall that will allow consumers to buy online but pick up items at a local Sears store, eliminating shipping charges altogether. Now in pilot testing, it has helped reduce shopping cart abandonment rates and

boost online sales. "We're helping customers go that last step in the online buying process," says Dennis Honan, general manager of Sears Customer Direct, which runs the Web site. Retailer Baby-universe.com has an on-screen shipping calculator, and CEO Neil Closner says customers praise it in e-mails. When it comes to shipping charges, "if they can control the decision, consumers are happier," says Closner. Or, at least, not feeling ripped off. •



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BY TIMOTHY J. MULLANEY

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Channel That Charity!

These Web sites can help you give in a way that's smart and compassionate

On some issues, Americans are still divided weeks after the attacks on New York and Washington that killed some 5,500 people. The best way to defeat terrorism is hotly debated. On other issues, we're united: We've opened our wallets wide since September 11. On the Internet alone, people have donated more than \$100 million. They are so eager to give that watchdog groups have

warned of e-mail scams begging donations for nonexistent charities. And so, the question: How do you give in a way that's as smart as it is compassionate?

A handful of Web sites stand ready to help. Some nonprofit sites solicited contributions and volunteer labor for prescreened charities even before the disaster. They can connect you both to charities born since the disaster and to groups serving long-standing needs. Other sites came along after September 11 and focus on directing money to relief groups in New York and in Washington. All will help you channel your dough to places where it will do the good you intend.

The best of the bunch is Helping.org, which achieves a rare twofer: It gives you the most information and the most opportunities to help. Run by the AOL Time Warner Foundation, the site offers detailed reports on the programs and spending of 700,000 nonprofit organizations. The reports follow the money that flows into these charities, using Internal Revenue

Service filings. You can tell which charity will spend your money on programs and which will blow too much on fund-raising and administration. Well-run groups like the American Red Cross spend less than 10% on operations, for instance. On each charity's report is a button that links you to a simple donation form. Helping.org takes no commission on the donations.

Another nifty Helping.org feature is a search engine that lets you find volunteer opportunities in your community. I found more than 1,100 volunteers-needed listings within 20 miles of my home—everything from pro bono legal services to coaching girls' track. After the World Trade Center catastrophe, it could tell you where to go to help at nearby hospitals. In most U.S. cities, I found about 800 listings.

Unlike Helping.org, Give.org will name nonprofits that meet their guidelines and those that either don't or won't provide necessary information for evaluation.

But it has reports on far fewer individual charities—only about 200—and its information is sometimes dated. Some people will think Give.org's pie-chart explanations of where donations go are easier to follow than Helping.org's rows of numbers.

Beyond these two sites, for-profit Web companies deserve some credit for helping to raise money. AOL, Microsoft, Yahoo!, Cisco Systems, Amazon, and eBay teamed up to build libertyunites.org, which connects to about 30 charities in New York and Washington.

Is the Web really a community? The idea took a beating when the dot-coms crashed to earth. But the response to the attacks shows the Net can be a powerful force for social good. Let's make the most of it. ■



Giving Till It Hurts

In the wake of the terrorist attacks, Americans are opening hearts and wallets. The Web offers clearinghouse sites that help you evaluate charities.



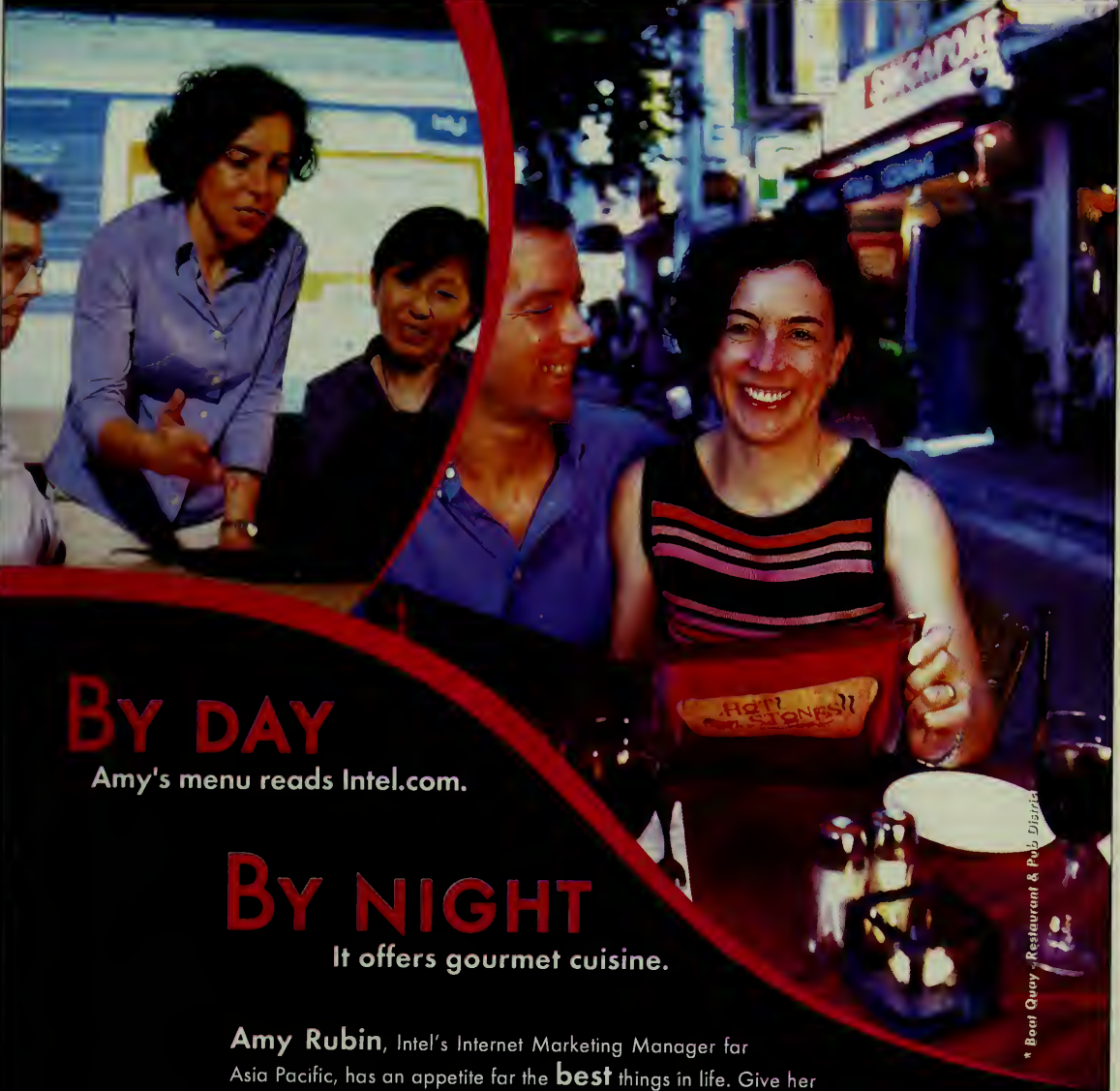
Helping.org: The best of the bunch. Data on thousands of charities, with links to make donations. A search engine matches you with volunteer opportunities near your home.



Give.org: Run by the Better Business Bureau, it offers some of the same info as Helping.org—but uses graphics to show how much of your donation will be spent on administration and fundraising.



Libertyunites.org: Site was created by six tech companies after the terrorist attacks. It channels aid mostly to New York agencies, especially for post-WTC relief.



BY DAY

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BY JOAN O'C. HAMILTON

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A Shadow in the Valley

The region's newest immigrants are feeling the effects of September 11

Should you visit Silicon Valley anytime soon, stay alert. There are so many pendulums reversing course around here that you could get smacked clear to Seattle. It's almost funny, for example, that venture capitalists now practically demand six quarters of profits and a Malcolm Baldrige Quality Award before they'll fund a seed round. But there's nothing amusing about an about-face that could

threaten one of the coolest things about Silicon Valley: the region's ethnic diversity and tolerance.

For decades here, brains and hard work—not race or class—have been the key to success. Tens of thousands of immigrants, particularly from India and China, have been valuable employees and have helped launch hundreds of companies, including Yahoo! and Sun Microsystems. Their friends and families have enriched our culture with restaurants, shops, houses of worship, even cricket leagues. One Sunnyvale (Calif.) area is so packed with Indian eateries and other shops that locals fondly call it “Gandhinagar,” or Gandhi Town.

But skilled immigrants are experiencing a wrenching shift. Just a year ago, tech execs were crying more, more, more! They said they couldn't stay competitive unless they hired more immigrants—since our own schools weren't producing. They pleaded for, and won, an increase in temporary H1-B visas from 115,000 to 195,000. (Some 138,000 had been approved by July 25, 2001, and typically more than half go to tech.) But even as they lobbied for the increase, layoffs were sweeping through Dot-commia, and within a few months even the biggest tech companies were cutting all kinds of workers by the thousands.

The H1-B situation is complex and controversial. Critics, for example, charge that many companies embrace it to avoid retraining older workers. Whatever your opinion, there's no doubt the economy's demise has left thousands of H1-B workers in a pickle. Without a job they are “out of status,” and must find new employee sponsors or leave. Indian business leaders say up to 2,000 Indians have returned home in recent months. Storefronts

of Gandhinagar now are plastered with “For Sale” signs for cars, stereos, and other items sellers need to unload fast. Says Kailash Joshi, president of The Indus Entrepreneurs organization: “H1-B visas were designed with only upside in mind.”

It's unfortunate that we invited thousands of new immigrants here just in time to experience the economic hangover of our big

Internet party. But it's downright tragic that since September 11 a few ignorant bigots have been harassing some of them and others based on their looks, dress, or last names.

As the year dawned, Aman Singh, 27, had a thriving cab business in Sunnyvale. Then the tech slowdown hit. “I'm getting so many calls,” even from H1-B programmers who need work, he says, but he can't offer any. The drop-off in air travel has idled half his 30 cabs. Most depressing is

that Singh recently had to summon the police when a group of white men started menacing one of his turban-wearing Sikh drivers. The cops arrived in time.

In the post-September 11 world, we realize a paradigm shift involves a lot more than a new button on a browser. So do our immigrants. “When there is fear and uncertainty, there will be insecure people who need to vent anger,” sighs Lata Krishnan, co-founder of chip company Smart Modular Technologies Inc.

Fortunately, that minority is still outnumbered by the open-minded and good-hearted: Krishnan heads a local foundation originally formed to send resources and technology back to India. It has temporarily suspended that activity so that it can raise \$1 million for the children of victims of the September 11 attack.

Harassers, what have you done for your country lately? •



Singh: Slow business—and harassment



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by

DAVID ROCKS

The Net As a Lifeline

A tough economic environment makes the Web even more important for companies attempting to cut costs, generate new revenues, and better serve customers

As America stood still in the wake of the September 11 attacks, casino and hotel operator Harrah's Entertainment Inc. faced a sharp downturn in business. The country was in no mood for a party, and few people

were willing to hop a flight to Las Vegas. Occupancy rates at Harrah's flagship hotel soon dropped by more than 25%. So on Sept. 14, Harrah's launched a small counteroffensive: The company sent out targeted e-mails to thousands of customers it thought might want to take a trip to the tables and slots. The gambit worked, helping to fill nearly 4,000 rooms that otherwise would have gone empty. By Sept. 30, the hotel was back near 100% occupancy. "We were able to get our message out immediately over the Internet," says Harrah's Chairman Philip G. Satre.

The key to Harrah's success: This summer, the company linked its database of 24 million gamblers to its Web site and e-mail marketing system. A year ago, Harrah's wouldn't have been able to seize the day. It has long known who the highest rollers are, based on its records of customer habits: Many avid gamblers participate in a rewards program that allows the company to track their playing, using

cards that can be plugged into slot machines or presented to pit bosses. Until this summer, though, reaching those players with targeted pitches required bulk mailings via snail mail. Now, when a customer clicks to Harrah's Web site from an e-mailed pitch, the company knows how much the player spends and can offer a tailored deal. The customer can then immediately book the room and a flight to get there, and reserve a seat for a show.

Harrah's beat the house odds. The September 11 attacks instantly made the toughest economic environment in a decade even worse. But for companies such as Harrah's that have spent the time and the money to beef up their Internet capabilities, the sting may not be as bad. With its innovative marketing, Harrah's rebounded more quickly after September 11 than other big casinos in Vegas, says Bear Stearns & Co. analyst Jason N. Ader.

Suddenly, the Internet has become a lifeline. Companies in a sales squeeze are

**Web
Smart**

PHOTO ILLUSTRATION BY BARBARA BELLINGHAM





looking to the Net as a tool for cutting costs, generating new revenue streams, trimming inventories, and serving customers and employees more efficiently. Sure, this was happening before the attacks. Today, though, those efforts are no longer just an advantage—they're urgent.

Still, jittery executives only want to fund projects that promise to pay off fast. With the military on the move in Afghanistan, consumer confidence flagging, and further terrorist attacks an ever-present threat, corporations fear the economy may be heading into a recession. So they are carefully choosing the Net projects they go ahead with based on hard-nosed calculations of return on investment. Vague Web initiatives that cost millions to simply build the brand are out, the residue of giddier dot-com days (page 26). "There's going to be a search for more short-term payback," says Hal Sirkin, e-commerce practice leader at Boston Consulting Group. "People are still thinking how to reinvent the compa-

ny, but they may not take the big leaps that they would have a few months ago."

The projects getting the green light are those with proven track records for delivering results. Companies are putting human resources and customer service online so they can reduce the number of

network that zaps invoices directly into the accounting systems of customers and suppliers. The project should pay for itself in six months, and within two years should cut 80% of the \$370,000 Fisher spends annually to process bills from suppliers.

The key is putting the money in the

"There's going to be a search for more short-term payback"

call-center employees. They're pressing ahead with supply-chain management initiatives—although often in smaller pieces than two years ago. And they're moving all aspects of purchasing to the Web, allowing them to slash internal costs or wring deeper discounts from suppliers. DuPont expects to save \$400 million a year buying supplies online. The initiative's total cost: just \$15 million over three years. And the British arm of laboratory-equipment distributor Fisher Scientific International Inc. is investing less than \$50,000 in an online

right place. While spending on Net initiatives isn't climbing as fast as it did a year ago, it's still going to rise by 9% over the next 12 months, according to AMR Research Inc. Granted, that's down from a predicted 11% increase before September 11, but better than the 3.7% increase in overall spending on technology Deutsche Banc Alex. Brown is expecting. The areas being funded? Supply-chain projects are now expected to grow by 9%, AMR says. Customer-focused initiatives, such as projects that let clients help themselves to

Web Smart for a Changed World

As corporate profits fall and companies adapt to a more sober reality in the wake of the September 11 attacks, spending on e-business initiatives is getting more focused—with a renewed emphasis on projects that promise a quick return. Internet outlays are expected to rise by 9% this year, compared with 3.7% for tech spending overall. Here's what's still getting funded.

WINNING CUSTOMERS

The problem: For years, Casino operator Harrah's has had a database of customers it woos with cheap hotel rooms. But getting promotions out meant using snail-mail. The info wasn't connected to the Web, so it was hard to craft timely offers.

The solution: Harrah's linked the database to its Web site, allowing customers to go online and book rooms at discount prices based on their past spending habits.

The payoff: After September 11, occupancy at Harrah's flagship Las Vegas hotel fell by 25%. The chain sent e-mails with bargain offers, filling 4,000 rooms that otherwise would have stayed empty and bringing the hotel back to near-100% occupancy by Sept. 30.



SMART PROCUREMENT

The problem: With the chemical industry in a slump and DuPont's earnings expected to slide by half this year, the company needed to cut costs.

The solution: One \$15 million initiative will streamline DuPont's purchasing of everything from software to sulphur dioxide. The project eliminates faxes and purchase orders, moving procurement online, where employees can order goods from suppliers that sell to DuPont at a discount.

The payoff: The company has cut procurement costs by \$200 million—a 5% reduction—this year, and expects another \$200 million in annual savings by 2003. Now, a typical order is processed in one day instead of five.

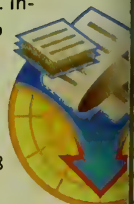


PAPERLESS PROCESS

The problem: Getting results of building inspections in Miami-Dade County was too slow. Inspectors schlepped to construction sites with pen and paper, then submitted reports to data-entry clerks. Results were available 48 hours later.

The solution: Today, inspectors fill out their reports on a wireless handheld computer, then zap them off to a Web site where they're posted minutes later for builders to see.

The payoff: The county estimates the \$880,000 project saves at least \$175,000 in payroll and other expenses annually and frees the data-entry clerks to field inquiries about permits and other matters.





Ricoh's Kaplan
is using a Web
product launch

info online, are going to see 6% growth. Product-development programs will grow by 5%. Indeed, most managers are keeping the Internet faith: An Accenture Ltd. study this summer found 57% of 840 execs worldwide say e-commerce initiatives are fundamental to their company's survival.

What might endanger that survival is too much emphasis on short-term results. With the economy slipping into a

recession, key longer-range projects could be put on hold. Most at risk: Squishier initiatives that don't show an immediate ROI, says Erik Brynjolfsson, co-director of the Center for e-Business at Massachusetts Institute of Technology. One example: knowledge management projects, which help companies better tap into and share the information their employees possess. "Firms that focus too much

on cost savings may miss out on the productivity gains down the road," says Brynjolfsson.

Getting those gains requires more than just a technology fix. Simply grafting computers and software onto existing business processes will do little to give a company the productivity boost the Web-savviest companies are seeing. The real payoff comes when companies change the way they interact with customers and suppliers, organize their factories, and move products around the world. PC giant Dell Computer Corp. has been honing its Web operations for years, so today it knows what parts it has and what it's going to need as orders stream in. Dell can do this because it requires key suppliers to be linked over the Web. The Net makes all of this work faster, but long ago Dell built its entire business around super-tight integration with both customers and suppliers. "The Web expanded Dell's capabilities, but much of the architecture of its success was in place before the Net," says David C. Mowery, a professor at the Haas School of Business at the University of California at Berkeley.

Dell's Web smarts allowed it to react quickly after September 11. While its efficiency put Dell at risk as borders were closed and air travel was shut down, it also helped the company make it through

DIGITIZING DEALERS

The problem: Dealers for office furniture maker Herman Miller had to phone company reps to track orders, get shipping dates, or product information—waiting up to a week to make final arrangements.

The solution: This summer, Miller completed a \$1 million project that links up to its 400 dealers via the Web, giving them easy access to info.

The payoff: Dealers say it helps them better serve customers by giving them instant access to order and shipping info without having to call. The company says facilitating access by dealers will encourage them to recommend its products over those of other makers.

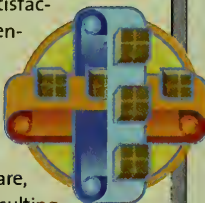


TUNING UP PRODUCTION

The problem: Mexican steelmaker Hylsa's Bar & Rod Div. needed to improve customer satisfaction and lower inventory costs at its two plants.

The solution: Hylsa spent \$800,000 on software, computers, and consulting to automate the process of planning production, managing inventories, and scheduling deliveries.

The payoff: The new system helped improve on-time deliveries from 70% to 88%, and boosted inventory turns—a measure of efficiency—from 2.2 to 2.8 times monthly. Next, the division plans to hook up electronically with its suppliers to coordinate production schedules.



PEOPLE POWER

The problem: Bank of America was spending nearly \$100 million annually on human resources paperwork such as enrollment for its retirement programs. Simple changes often required weeks to complete.

The solution: The company moved those programs to the Web. Managers now log on to record promotions and raises. And all 140,000 employees can change doctors, monitor retirement accounts, and submit travel expenses online.

The payoff: The bank is saving with the system. Some processes, such as benefits enrollment, now take just minutes to process because they're done online. That's down from months under the old system.



PeopleSoft Bringing Systems to Services

In this day of accelerated business schedules and narrow profit margins, few large companies that manufacture, distribute, or sell products would risk operating without the efficiencies and cost savings made possible by an automated Enterprise Resource Planning (ERP) and supply chain system. Yet this is exactly the situation faced by most large service organizations, which are engaged in a complex and time-critical manufacturing process as well—not of physical things, but of human billable hours.

Consider some of the key activities undertaken every day by large service organizations like management consulting firms, law firms, accounting and tax practices, architectural and engineering firms, and computer and technical consultancies:

- Planning sales, taking orders, and drafting contracts (i.e., managing the sales process)
- Assessing inventory and capacity (i.e., identifying available staff)
- Acquiring raw materials (i.e., recruiting staff)
- Applying raw materials to the production process (i.e., staffing and resource management)
- Managing production (i.e., project management)
- Collecting payments and determining profitability (i.e., billing and performance measurement)



Similar Processes, Similar Needs

What should be clear is that, despite the enormous differences in the nature of their output—tangible products versus intangible professional services—the processes involved in delivering professional or business services are virtually identical, at the conceptual level, to those involved in producing products. Nevertheless, prior to last year, no major ERP vendor had provided the full range of software necessary to manage the resources and processes of sophisticated service organizations.

And yet, from a timing and efficiency standpoint, managing services-related processes can be just as important as managing production-related operations, if not more so. On average, according to the Gartner Group, a market research firm, companies spend an average of 54% of their purchasing dollars on services—more than twice as much as they do on other cost categories, including raw materials and operating goods. Not only pure service firms but also product-centered firms with internal or external

service divisions (e.g., an internal IT unit, an external consulting division) could therefore benefit from more timely and efficient allocation of their service resources.

In 1996, Ernst & Young (now part of Cap Gemini Ernst & Young) became convinced of the need for a comprehensive “service automation” solution. Experiencing rapid growth in both the volume and type of services they were offering, the firm’s executives knew that they needed to better understand which projects were making money and which weren’t (and why), which business units and locations were producing the best results, and how well its consultants were being utilized throughout the firm. These were questions that simply could not be answered by the firm’s home-grown information systems.

Unfortunately, subsequent research showed, none of the then-existing ERP software solutions met these needs either, but those supplied by market-leader PeopleSoft came the closest. So Ernst & Young managers worked side-by-side with PeopleSoft engineers to adapt the latter’s core ERP products to the specific requirements of service organizations like E&Y. The result of this and other efforts by PeopleSoft was a new Enterprise Services Automation (ESA) suite of software, introduced in September 2000 as part of the company’s Release 8.0.

Essential to Survival

Since the arrival of the ESA software suite, Cap Gemini Ernst & Young (CGE&Y) has worked with PeopleSoft and its clients to implement PeopleSoft’s ESA solution in a wide range of service environments. And demand has hardly been lacking. Within less than six months, PeopleSoft had acquired more than 80 blue-chip customers, including such well-known professional and business services firms as American Express, BEA Systems, FedEx, Lotus, Microsoft, Visa, and Wells Fargo.

The key to this success, says CGE&Y vice president Les Poinelli, is that ERP vendors like PeopleSoft are now focusing closely on the unique needs of service companies and service-oriented units within larger product companies. And the first several months’ success, he believes, is but a mere beginning. “As competition increases in the services market,” he predicts, “the services supply chain solutions such as PeopleSoft’s ESA suite will become as necessary for the survival of these companies as ERP and supply chain solutions have been to the companies that produce products.”



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the disaster without a hitch. When the attacks began, Dell instantly sized up its operations and figured out where supplies might be disrupted. It quickly ramped up production in factories in Europe and Asia and filled orders from there. And with the Web giving it a real-time view into orders pending, it prioritized orders and filled the most important first. At the same time, Dell salespeople were able to look online to see the configurations that could be assembled and shipped quickly despite the disruption—and then steer customers accordingly. “The company with the most

efficient supply chain was able to weather this the best,” says Dell Chairman Michael S. Dell.

Indeed, companies that lost computers in the attacks were asking for thousands of replacements. The upshot: Dell expects a profit of \$410 million for its third quarter ending Nov. 2, while competitors Compaq Computer Corp. and Gateway Inc. have told Wall Street to expect losses. Compaq was unable to ship \$300 million worth of computers due to supply-chain disruptions after the attack.

Other companies are more fully embracing the Web. Copier maker Ricoh Co.,

for example, had long planned a gala sales meeting for more than 3,000 customers on Sept. 12 at the Jacob K. Javits Convention Center in New York City. The event, headlined by former Vice-Presidents Al Gore and Bob Dole, was designed to show off Ricoh gear and unveil a new online service for storing and sharing documents via the Web. As the terrorist attacks unfolded less than 24 hours before the gathering was scheduled to start, Ricoh quickly cancelled the meeting. The event is now likely to be rescheduled for next year, but Ricoh didn't want to wait that long to introduce the new service, called Document Mall.

Instead, Ricoh turned to the Web. The company plans to go ahead with the launch using a collaboration service called WebEx, which lets people see and talk to each other while sharing files online. This fall, 6,000 Ricoh salespeople and customers will be invited to Web seminars on Document Mall. Ricoh estimates it will save at least \$60,000 in travel expenses, as well as countless employee-hours of flying and trundling

through airports—while keeping skittish workers closer to home in these troubled times. “It's much more productive for us to do the rollout this way,” says Isabel Kaplan, Ricoh's head of e-business marketing.

These days there's a lot less experimentation in Web projects. For example, two years ago Otis Elevator Co. thought it could goose its revenues by placing screens linked to the Web in elevator cars. These would present a constant feed of news—liberally salted with ads. Problem was, during the Internet boom years Otis faced upstarts with oodles of venture-capital funding that were giving away similar screen systems for free, making up the difference in ad sales. “The business model doesn't work with free screens,” says Ron Beaver, Otis' vice-president for information systems. A year ago, Otis jettisoned the initiative.

You might think that was the end of Otis spending another penny on Internet projects. Wrong. This year, it more than doubled its Internet budget and expects a 50% increase in 2002. The bulk of the new money will go to an effort linking

Fisher Scientific UK

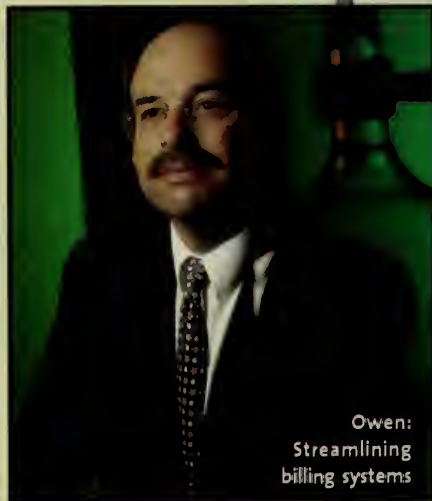
The most sophisticated e-businesses still grapple with vestiges of the past. Consider Fisher Scientific UK Ltd., Britain's largest seller of laboratory supplies and a unit of \$2.6 billion U.S.-based Fisher Scientific International Inc. Like its parent, the British company makes extensive use of the Web, distributing electronic catalogs every month to its 40,000 customers and selling 75,000 products online. Still, it sends and receives more than half a million paper bills every year. For business-to-business sales, paper still rules.

Enter a cheap solution. Starting last month, Fisher Scientific became the second customer for a new Web-invoicing system from London startup Open Business Exchange (OBE). The technology promises to slash Fisher's payment-processing costs by 80% within two years. The OBE system, which launched last July in the U.S. and Britain, acts as an electronic hub between buyers and sellers. It converts digital invoices from suppliers into a common template and then zaps the information directly into purchasing companies' accounting systems.

The savings already are showing up for Fisher Scientific. The company spent less than \$50,000 to sign up with OBE and tweak its computers to talk to the network. A pilot test this summer generated high accuracy rates and positive responses from suppliers. Now, says project manager Paul Owen, Fisher expects to pare its cost of handling incoming invoices—already a slim \$4.35 per bill—by 25% within a few months. Before using OBE, Fisher spent \$370,000 a year processing bills from suppliers. The OBE system “will pay for itself in six months,” Owen says. As more suppliers join up, the results will get even better.

Fisher's suppliers are making the switch because it will save them big bucks, too. Nickel-Electro Ltd., for instance, used to spend every Friday afternoon printing and mailing bills to Fisher. Now, says operations director Adrian Ross, “I can use that time to do something more productive than processing invoices.” If Fisher Scientific later persuades its customers to accept electronic invoices as well, the savings could pile on, and paper bills would be a thing of the past.

—Andy Reinhardt in Paris



Owen:
Streamlining
billing systems

Herman Miller

Even companies that are in financial distress need to keep pushing their e-business initiatives—albeit at a slower pace. That's the approach being taken by Herman Miller Inc. The office-furniture maker rode the economic boom with everyone from dot-com upstarts to General Motors Corp. snapping up its black Aeron chairs and trendy modular desks and cubicles. When the economy dove, so did Miller. In its fiscal first quarter ended Sept. 1, the company's sales fell by 25%, to \$410 million, and it lost \$2.9 million, down from a profit of \$32.5 million a year earlier.

As Miller managers looked to cut costs, one obvious target was the company's tech budget. While Miller was an e-business pioneer as the first office furniture manufacturer to sell its products online, it could no longer afford tech spending of \$100 million a year. The company is planning to slash tech outlays by 25% in fiscal 2002. Miller is slowing the pace of its biggest Web project, a multiyear effort to build a corporate portal. This project would give employees, suppliers, and customers a view deep inside the company's operations. While Miller expects to reap financial rewards from the portal, it won't deliver results quickly. "We can't afford to be as aggressive as we were before," laments Gary V. VanSpronsen, Miller's chief information officer.

Even so, the company hasn't pulled the plug. Miller has continued with a more modest initiative, called Kiosk, that helps its 400 dealers follow the progress of their orders with just a few mouse clicks on the Web. Before Kiosk

VanSpronsen
is being less
aggressive



was rolled out this summer, dealers could submit orders electronically, but they needed to call the company to change an order or check on its status. For Miller, the \$1 million project was attractive because it was affordable and could be finished quickly. Although the company can't yet point to exact cost savings, VanSpronsen says usage of the system has grown fivefold since June, indicating that dealers find Kiosk helpful in serving their customers. "If you have to pick one thing, you go with what can make a practical difference in your business today," VanSpronsen says.

He hasn't given up on his dream, though. As soon as the economy turns around, the portal will be back on track.

—David Rocks in New York

Otis with its suppliers and customers via the Web to streamline the way parts move in and out of its factories. Beaver estimates that half the elevator parts Otis sends out to construction sites arrive before they're

alerting Otis to send someone to fix it. Today, some 20% of elevators Otis maintains worldwide use the system—a number it hopes to nearly double by the end of next year. The payoff is huge: Since Otis no

ant expects another \$200 million in annual savings by 2003—numbers that sound pretty good at DuPont, where analysts expect to see profits slide by half this year. Before the system was in place, employees ordered supplies, such as pipe fittings and lab chemicals, using phone calls, faxes, or by simply running out and picking stuff up. Now, employees log onto a Web site to buy virtually everything. DuPont can better control what gets bought—and can funnel orders to vendors who promise price breaks.

Corporate chieftains are figuring out that the Net can help them better weather tough times. No doubt, the terrorist attacks made a bad situation worse. But economic turmoil also creates opportunities for those who place their chips on the right numbers. The smart money is betting that getting Web smart is like having an ace in the hole.

Contributing: Andrew Park, Aixa M. Pascual, Darnell Little, and Jeanette Brown

Dell's Web smarts allowed it to react quickly after September 11

needed, and end up sitting around for weeks or months, meaning the company carries them as inventory much longer than necessary. The new Web system should help the company better monitor whether a cable, a cab, or a carton of call buttons is ready to ship, because it will be in constant contact with its suppliers. And with progress reports available online, Otis will know what stage the builder has reached and when it's ready for each part.

Otis also is tapping the Net to slash repair bills. The company has a system that allows technicians at 10 centers around the globe to monitor elevators via a Net link. When a door sticks or the car doesn't stop at floor level, the elevator zips off a signal

longer has to dispatch repair staff as often to check for problems, elevators with remote monitoring require only one-third the number of visits as those without the system. That has helped Otis keep its North American repair staff steady while increasing the number of elevators it services by 10%, to 120,000, over the last year.

These days, Web projects must be no-brainers. The payoff from some simple initiatives such as moving procurement online can be so huge you wonder why they didn't happen years ago. At DuPont, for example, purchasing on the Web has cut the cost of buying supplies by \$200 million—a 5% reduction in the first year of the \$15 million project. Better yet, the chemical gi-

e.biz online

For more on the Web efforts of food giant General Mills and Hong Kong's Convenience Retail Asia, visit ebiz.businessweek.com.

by

STEVE HAMM

Sizing Up Your Payoff

Forecasts of gains from e-business investments don't always pan out

Last year, when Jonathan Wharton, the e-business manager for Canadian energy producer Suncor Energy Inc., began sizing up the potential benefits of a new package of Internet software, he didn't take his supplier's claims at face value. The idea was to install Plumtree Software Inc.'s corporate Web portal to help Suncor's 4,000 employees get information and communicate better.

Using a workbook Plumtree provided to help estimate the return on his roughly \$1 million investment, he initially calculated a \$13 million annual bounty. But Wharton tossed out a handful of items—including a \$10 million revenue gain due to better dissemination of information.

It could happen, but he wouldn't count on it. He came up with a more conservative number: \$2 million. "We're a tough audience," says Wharton. "I needed to have something I could believe in and could convince my boss to believe in."

Ultimately, the deal was done. Wharton is confident he will pay for his initial investment within eight months after the software starts running next year. And while the process of sizing up the potential benefits was bumpy, he wouldn't dream of buying software without first going through the exercise of calculating his return on investment—or ROI.

Wharton is at the forefront of a phenomenon that's sweeping the corporate world: the ROI study. In the Internet's heyday, corporations didn't demand proof that e-business projects would save them money or boost revenues. Today, many corporations won't commit to new tech purchases unless they see the benefits spelled out in black and white. So tech

companies are devising all sorts of studies to persuade customers to buy.

As vital as ROI analysis has become to corporations, not all studies are created equal. And some promise returns that will never materialize. Online calculators—

where a company asks questions about a business and gets answers based on a formula—give only rough estimates of possible savings. Case studies of companies that have completed projects don't necessarily apply to companies in other industries. A detailed analysis of

an individual company's prospects should yield more useful results, but even then, variables such as an economic slowdown are hard to anticipate.

Not surprisingly, ROI studies tend to be overly optimistic. Only 28% of major tech projects fully meet expectations, according to researcher The Standish Group. Yet a September survey of nearly 500 corporate information technology executives by researcher Jupiter Media Metrix Inc. showed that 59% of their do-it-yourself ROI studies forecast gains.

To get dependable assessments, corporations need to drill deep into the numbers. They have to identify their variable costs, then calculate the money they can save or the new sales they can log adding

technology. This can be a major undertaking. Consider electronic controls company Cutler-Hammer, a division of Eaton Corp. A three-month study that led to buying Metreo Inc. software to automate the company's pricing system involved interviews with 200 staffers. Cutler-Hammer calculates it will take 18 months to pay back the \$250,000 cost of the first phase of the project, started in May. Already, the time it takes to analyze a new piece of business and come up with a price has dropped by 40%, to four days.

By contrast, ROI calculators can give rough estimates in as little as 10 minutes. The calculators, often on a supplier's Web site, walk a company through a series of questions, and then spit out a forecast based on the answers. These estimates are the least reliable of all the ROI approaches. When Polly Foote, a human resources business analyst at plumbing distributor Ferguson Enterprises Inc., used the basic version of PeopleSoft Inc.'s ROI calculator last June, she came up with an estimated 400% return on her investment in human resources software over five years. "That was unbelievable," she says. So she spent two weeks coming up with her own calculations—yielding a 77% internal rate of return, which takes into account the cost of money and other factors. Ferguson bought the software.

**Web
Smart**



Even though tech suppliers have an obvious bias, they also have expertise that can help customers size up their products. Intraspect Software Inc., a Brisbane (Calif.) maker of knowledge management software, two years ago forecast a \$1.5 million return in 12 months on an initial \$280,000 investment by customer Hill & Knowlton, a public relations firm. Ultimately, the return was even better, \$2 mil-

lion, according to Edward W. Graham, Hill & Knowlton's director of knowledge management. Intraspect led Hill & Knowlton people through a series of questions about each of their business activities—such as prospecting for new clients—and helped them estimate exactly how much time they could save on each piece of the process by using its software.

It's prudent to get a second opinion,

though. Consultants such as Gartner Inc. and Meta Group are the least likely to forecast a false-positive ROI since they have no vested interest in the outcome. "An external consultant can be your best bet. They've got a proven methodology and can benchmark you against others in your industry," says David Taylor, research director at Jupiter Media Metrix.

Doing follow-up studies after a new technology is running can confirm whether it delivers as promised. Sometimes they even reveal pleasant surprises. Computer Services Solutions, a \$185 million Dutch computer systems integrator, bought SAP supply-chain software to create online links with its suppliers of technology gear. Rather than storing computers in its warehouses, it arranged with suppliers to have them shipped directly to its customers. That allowed it to close its warehouses, eliminating \$13 million in inventories. Then came the bonus. Through an audit of results by Andersen, CSS figured out it could use the same software to provide online purchasing for corporations. The result: a spin-off, Atcostplus, which links companies with their suppliers via Atcostplus' data center.

ROI studies aren't an exact science. But in times such as these, measuring results is a vital discipline. It could mean the difference between running efficiently and being an also-ran. ●

Running the Numbers

Here's the skinny on the most common methods of assessing ROI:

Quick calculators: These are fill-in-the-blank forms, often on the Web sites of tech companies. Potential customers plug in facts about their business and get a ballpark estimate of how much they can save.

How useful: Because the formulas are so general, experts don't consider them to be reliable forecasts of savings.

Case studies: Tech outfits often trot out case studies of completed projects to try to persuade potential customers to buy their products.

How useful: Problem is, each company's situation is different.

ROI forecasts: Detailed info about a company's technology and business performance is collected and compared with results from its peers.

How useful: This is fairly reliable because it focuses on one company.

ROI assessments: These studies are done after a project is finished.

How useful: The approach is highly accurate. But because it's done after the fact, it doesn't help with buying decisions.

Siefkas: Better
Web tools at Deere



Let's Get Back to Basics

Many companies
e-biz strategies used
be jumbled messes. Now
they're getting focus

During the Internet boom, the Web philosophy of many companies could be summed up in one sentence: Let a thousand Web sites bloom. Today, though, under the weight of a deteriorating economy, Corporate America is applying some weed killer to its digital gardens.

Companies short on patience and shorter on cash are stepping back and trying to figure out what has worked and what hasn't in the online world. Out are all the willy-nilly Web sites started up by department heads and individual staffers for projects that didn't advance the company's overarching goals. Forget experimental Web projects that have not yet shown a

return on investment. Wave goodbye to glitzy marketing sites where the trappings were so gaudy that a Web surfer couldn't find a simple search button.

Instead, executives are demanding to see proof of future returns before deciding to keep projects going. Top management wants Web initiatives tied directly to core business goals, such as better relations

with customers and more emphasis on brand-building. "People are going back to two things: What is the strategic rationale for getting into this, and what is the return on investment?" says Tim Byrne, a vice-president at Mercer Management Consulting.

Three companies have spent considerable time figuring this out. Their sagas hold lessons for any business now struggling to untangle its snarl of Web sites.

CITIGROUP

Few companies blew more money trying to build independent Web divisions than Citigroup, parent company of Citibank, Salomon Smith Barney, and Travelers Insurance. In 1997, it launched e-Citi with

FAITH KEENAN AND TIMOTHY J. MULLANEY

Untangling the Web

In the rush to the Net, many companies let departments throw up Web sites with little regard for how they would help the overall business. Now they're trying to untangle their Net initiatives and get them focused on their core business. Here's a sampling:

	THE OLD WAY	THE NEW WAY
Citigroup	In 1997, Citicorp set up e-Citi as an incubator to come up with Web businesses. E-Citi spent \$1.1 billion and launched an Internet-only bank called Citi f/i, which landed only 30,000 customers and created tension with other bank units.	A Corporate Internet Operating Group oversees Net strategy, with e-Citi providing technical support. Now Citi has 38 U.S. sites, down from over 100. Citigroup says moving its back-office functions online will save \$1 billion-plus next year.
Ryder System	Separate divisions put up 10 Web sites for everything from selling used tractor-trailers to emergency roadside service. But many didn't link to the corporate site, ryder.com. And its shipment-tracking service was buried 10 clicks deep into the ryder.com site.	All the company's Web sites are now linked to ryder.com. A redesign helps customers locate their shipments within two clicks. Now Ryder uses the Web to coordinate its picking, packing, and shipping for customers.
Deere & Co.	Managers launched 13 Web initiatives, serving markets that generated little revenue. Deere makes most of its profits selling new construction equipment, yet it had three sites for used equipment.	The company merged the Web sites into deere.com. Now customers can buy new or used equipment, seek service or repairs—or even use the Web site to configure their own gear, a first for Deere.

high hopes and a big task. E-Citi's job was to keep all of Citigroup on its toes—partly by competing with the very bank, credit-card company, and other businesses that made Citigroup a \$230 billion giant. There was to be an e-Citi bank called Citi f/i and a financial portal called finance.com. The maverick unit soon had 600 employees and more than 100 U.S. Web sites. The idea: Cannibalize your business before someone else did.

The only thing e-Citi gobbled was money. Citigroup's Web effort lost over \$1 billion between 1998 and 2000. In online banking, for example, Citigroup was so determined to make Citi f/i an independent operation that customers of the online bank couldn't use Citibank branches. That turned off depositors. The online bank drew 30,000 accounts, vs. 146 million for the rest of Citigroup's banking operation. By March, 2000, word came down from Citigroup Chairman Sandy Weill: Web initiatives must be part of the existing business, not self-appointed upstarts trying to overturn them. "At the beginning of 2000, people were dreaming that you could take e-Citi public," says Deryck

Folks!

Maughan, Citigroup's vice-chairman. "I looked very carefully [and asked], could it make a profit? Not in our lifetime."

Still, Citigroup wanted to keep ideas flowing and innovation humming. So last year, the company formed an Internet Operating Group of top execs to help Citigroup units share Web technology and to ensure that they all have a common look and feel. Innovation is still bubbling along: Citibank is making a big play in the online-payments business with its C2It service, which lets consumers e-mail money to each other for a 1% commission.

A year later, the results are easy to see. The number of online customers are up 30% because Citibank and Citi's credit-card operations are pushing Web services themselves, instead of leaving that mostly to

e-Citi. Citigroup now serves 10 million customers online. E-Citi has been scaled back to 100 people, who implement projects the operating groups propose. The 100 Web sites have been trimmed to 38. The reported loss for online efforts in the first half of this year was down 41%, to \$67 million, from \$114 million a year ago. And counting savings from moving procurement, human resources, and other back-office functions online, Citigroup says Web technologies will cut \$1 billion off annual costs by next year. "I promise you, we are going to be saving a lot more than we are spending," Maughan pledges. Now, Citigroup has a chance of seeing profits from its Web efforts in Maughan's lifetime.

RYDER SYSTEM, INC.

Almost daily, Ryder System executives want to curse those yellow trucks. You know them—the can't-miss-'em rental vans. Ryder sold that business five years ago to concentrate on leasing commercial trucks and handling the transportation and logistics needs of other firms. But

the company still gets regular queries—many via e-mail—about moving vans.

At least one Ryder executive thinks of the yellow trucks as a beacon in the night. John Wormwood, the company's director of e-commerce solutions, credits them with alerting Ryder to its Web mud-

dle: It was consumers seeking to rent a van who pointed out what a mess the site was. "We got feedback from [would-be renters] saying 'the Web site is unusable, difficult to navigate,'" says Wormwood.

About 10 sites had sprung up, some without a link to Ryder.com, the corporate site that explains the company's business. Although Ryder sells used tractor-trailers, for instance, buying them online required a visit to usedtrucks.ryder.com. "It was really a patchwork quilt of navigation, colors, and styles," says Wormwood.

Ryder needed to unravel the threads. In late 1999, it created an e-commerce group, including staff from all its major divisions. They agreed that Ryder needed a common look and produced a style guide



Rethinking Your CRM Solution?

Whether business-to-business, business-to-consumer or government-to-citizen, organizations are exploring the potential of CRM to enhance customer value, reduce expenditures and provide competitive differentiation—and Unisys is providing collaborative strategies to help organizations achieve successful CRM implementations.

Exceptional customer service is about unifying internal business operations with your business strategy and customer service goals. CRM efforts must be flexible enough for your company to continue to expand and enhance its customer relationship efforts. Most of all, it is important to select a solutions provider that can maximize your existing environment and grow with future business, customer and technology requirements.

Unisys offers a holistic approach in providing CRM solutions by starting early in the planning stages with business process consulting, application integration, solution implementation, and ongoing support.

It is clear that today's customers and clients are smarter and demanding more than ever before. That is why "Unisys partners with the leading CRM software and platform companies to provide complete end to end solutions," notes Bill Tatnall, Vice President of Global CRM Solutions at Unisys. "And we have years of experience on virtually all platforms and applications, so the multi-vendor environment is a familiar one to us."

To learn more about how Unisys can help you re-think and complete your CRM efforts visit: www.aheadforebusiness.com

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to lay out where logos, photos, and text should go on all Ryder Web pages.

A renewed focus on customers, and on making it a snap for them to use the Web, has driven the \$5.3 billion company's e-strategy ever since. In a year when many companies are cutting their tech budgets, Ryder upped its spending 15%, to \$100 million. Of that, \$500,000 went toward a Web-site makeover this year. Before the redesign, it took 10 clicks to track a shipment. Since the new site was launched in July, the function is just one click from Ryder's home page. Before, there was no search mechanism. There is today.

These and other improvements have

Citi says the Web will cut \$1 billion off annual costs by next year

helped Ryder attract new customers, including Northrop Grumman. The defense contractor hopes to cut its transportation costs by taking advantage of better rates Ryder gets through bulk buys of cargo space. Northrop is pleased that it can electronically track the shipments every step of the way, so that it can adjust to any possible snafus. "We're able to pull out a lot of manual processes that sometimes introduce errors," says T. W. Scott, director of supply-chain management systems. And when parts arrive at a Northrop factory, you can be sure they won't be traveling in a yellow truck.

DEERE & CO.

When the e-commerce craze hit in the mid-1990s, managers at equipment-maker Deere & Co. motored onto the Internet like everyone else. The 13 major Web initiatives that just one division put up, though, were narrowly focused, with overlapping missions. Three sites focused on used equipment alone: one to list it, one to sell it through an online marketplace, and one to support used-equipment dealers. The sites targeted Deere's largely Web-allergic dealers, not customers who bought Deere products and might save time by locating parts or seeking repair know-how online.

Two years ago, with the sites developing little traction, Deere figured there had to be a better way. So it hired consultants to help organize its site and advise the company on overall Net strategy. By the

end of 2000, a plan was in place: The \$13 billion company would create an e-business group to oversee Web initiatives for its financing arm and its equipment divisions targeting farmers, consumers, and construction companies. Deere would create one Web site with areas for each customer group, and it would enable customers to search for parts or information about equipment online. The site offers "a new set of tools that will be applied to everyone's day-to-day business," says Kirk Siefkas, Deere's chief information officer.

By centralizing everything at deere.com, the company not only controls its corporate

image but also makes life easier for its 4,000 independent dealers and their customers. Consider the case of Brent Møllergaard, president of Circle Lazy H. Inc., a farm in Ellensburg, Wash. In the past, if he needed a new part for a machine, he would simply eyeball it and tell the local dealer what he thought he needed. Mistakes would happen, and he might lose time in the field by having to reorder the part. In April, Deere gave farmers access to JDParts at deere.com. Now Møllergaard can check the parts online, find a clear drawing, description, and stock number, and be sure that he is ordering what he needs. "There are a lot of parts that it helps with," he says. "It's hard to tell them apart sometimes."

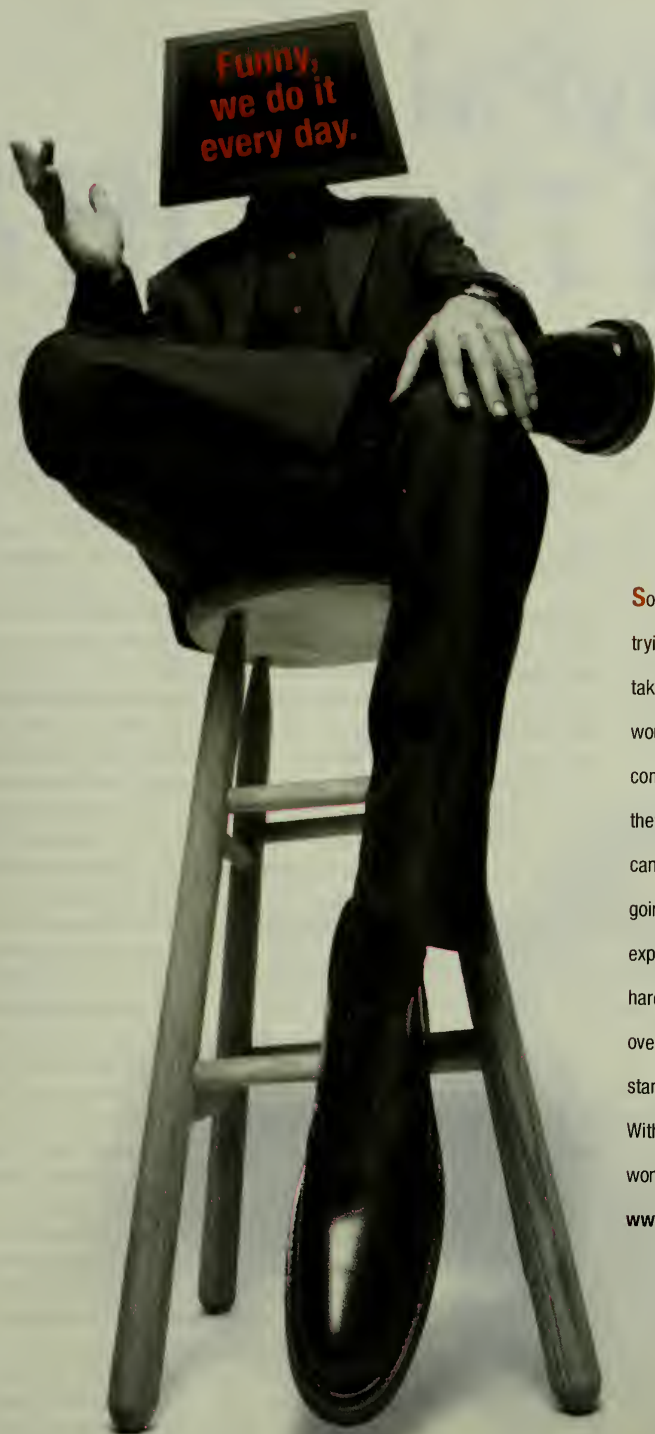
Deere aims to make life easier for buyers of heavy equipment as well. It plans to roll out online tools that let customers configure their own backhoe loaders, combines, lawn mowers, or other machinery. They no longer have to flip through several-inch-thick catalogs or negotiate with dealers, saving everyone time.

What does Deere get out of all this? It hopes customers will stick with the company because it's easy to do business with. That, in the long run, is likely to prove more valuable than trying to make money through a used-equipment marketplace. ●

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For a Q&A with Citigroup Vice-Chairman Deryck C. Maughan, go to ebiz.businessweek.com.

They say, in **e-business**, it takes forever to unify the past with the future.



Some e-business consultants will tell you trying to integrate your legacy systems takes too long and costs too much. They would have you scrap what exists and commit to whatever vision of the future they're selling that day. Unisys people can unify what you have with what you're going to need, using our decades of experience, ingenuity, and plain old hard work. And we do it every day, in over 100 countries. Today is the day to start unifying your past with the future. With Unisys people there to help, it won't take forever. Visit our website at www.aheadforebusiness.com.

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Can PayPal Pull This Off?

Why it's doing an IPO now is a mystery—but other Net upstarts could benefit

In an Internet market starved for success stories, PayPal is one of the few upstarts brimming with potential. Still, the Palo Alto (Calif.) company, which handles payments for buyers and sellers on the sites of auctioneer eBay Inc. and other e-commerce players, left

the high-tech world agape when it filed paperwork on Sept. 28 for an \$80 million initial public offering. The move came just 17 days after hijacked jetliners crumbled the World Trade Center towers and knifed

into the Pentagon, killing thousands and pretty much guaranteeing a U.S. recession. Investors are so skittish that not a single company went public in September, the first month without an IPO since Gerald Ford was in the Oval Office.

What gives? PayPal Inc. can't offer a public explanation because of the Securities & Exchange Commission-mandated quiet period for pre-IPO companies. However, interviews with analysts and investment bankers, and an examination of the company's IPO paperwork, shed some light. PayPal isn't desperate for cash. The company boasts \$135 million in cash and short-term investments as of June 30—enough to fund the company for two more years.

The likely catalyst for PayPal's IPO bid: It has taken a hefty, if tenuous, lead in handling online payments for consumers and small businesses and is seeking to cement its position before well-heeled rivals can make up ground. PayPal says it

has 65% of the market for electronic payments in online auctions, vs. 25% for Billpoint Inc., which is majority-owned by eBay. Billpoint's revenues soared 181% between the first and second quarters of this year, much faster than PayPal's 36% growth—although Billpoint started from a much smaller figure. PayPal, which spent only \$45,000 on advertising in this year's first six months and relied on word of mouth to build its customer base to over 10 million accounts, would benefit greatly from the increased visibility and respect that come with a successful IPO.

Another reason for PayPal's IPO filing could stem from its efforts to sell the company. Earlier this year, PayPal executives discussed selling to eBay, Citibank, and other companies, but no one would approach PayPal's asking price of more than \$700 million, according to analysts and investment bankers. Filing to go public may put pressure on would-be buyers to boost their offers. "They've probably got dual [financing] strategies," says a Wall Street analyst who follows Net-payment companies and insisted his name not be used to protect his relationship with PayPal.

PayPal could end up outsmarting itself. If public investors won't meet the company's asking price, which analysts believe will value the entire company at \$700 million to \$900 million, PayPal could find itself in a tight spot. Does it drop the price of the IPO and force its private investors to take a haircut? Or does it withdraw the offering and focus on negotiating with potential buyers—albeit from a weaker bargaining position? "I still can't make sense of the [IPO] timing," says Gartner Group Inc. analyst Avivah Litan.



Although its IPO may be a tough sell, PayPal has quite a bit going for it. By providing easy-to-use accounts from which buyers and sellers can instantly exchange money over the Internet, PayPal has become popular among eBay users who had previously been sending checks in the mail and trusting that sellers would deliver the goods as promised. In the past six quarters, PayPal's customer ranks have jumped more than tenfold, to 10.5 million accounts, generating \$750 million in transactions. PayPal's take: 2% to 4% of each sale, depending on the amount of monthly business the seller does, as well as 30¢ per transaction.

Even more impressive is the fact that it

mobile-phone giant Nokia Corp. When Confinity introduced the PayPal service in 1999, its focus was on letting people make payments with their mobile phones. But the mobile-commerce market was slow to develop, and Confinity sold out in March, 2000, to X.com, a Palo Alto company that was developing a finance Web site. During 2000, X.com recognized that many larger companies, including E*Trade Group Inc. and Yahoo! Inc., were far ahead in building successful finance sites. So X.com founder Elon Musk shuttered its online finance operations, renamed the company PayPal, and concentrated on electronic payments. Today, PayPal's 33-

next year's revenues. Assuming PayPal hits the highest analyst estimates of \$100 million in revenues this year and can somehow double that to \$200 million next year, the same multiple would put PayPal's valuation at roughly \$500 million.

Even that is no sure thing. While the IPO market is rough for any company, it is even worse for Internet upstarts. Only one Net company, Web-hosting startup Loudcloud Inc., has been able to go public this year—down from 129 Internet IPOs in 2000, according to market researcher IPO.com. Loudcloud's stock has plunged 77% since its March offering. Investors are particularly wary of unprofitable companies, and PayPal is not slated to make money for at least two more quarters. "The company lost \$170 million last year, and its maximum offering would raise \$80 million. Ratios like that always make me a little uncomfortable," says Marc Baum, CEO of IPO.com.

With the interval between the SEC filing for an IPO and the actual offering doubling on average (since the start of 2000) to nearly 140 days, PayPal will likely get at least one more quarter to bolster its numbers before testing investor appetites. With scores of Internet companies searching for any glimmer of hope, PayPal executives aren't the only ones hoping they can pull it off. ●

PayPal's link to eBay has sparked some investor interest

PayPal outpaces eBay-owned BillPoint on the auction giant's own site. Some 70% of eBay sellers have signed up for PayPal, vs. 30% for BillPoint. PayPal's popularity feeds on itself, as buyers and sellers flock to the payment platform where they can transact with the largest network of people. "PayPal is easy to set up, and it has people using it. That's why the business has worked," says Paul Royka, owner of Appraisal Day Gallery, which does all of its business through eBay auctions and PayPal transactions.

PayPal's financial picture, especially its link to eBay's thriving business, has sparked at least lukewarm interest from institutional investors. This year's first-half revenues of \$34.2 million are up from \$3.3 million in the same period last year. Although PayPal lost a total of \$56.9 million in the past two quarters, \$32.8 million of that came from amortization of goodwill, a charge that doesn't cost the company cash. A true viral-marketing company, where word-of-mouth brings in most new users, PayPal spent only 14¢ to add each new customer account in June, down from \$6.30 per account last year. "This is a growth story," says senior analyst Paul Bard of Renaissance Capital's IPO Plus Fund. He says he may be interested in a PayPal offering. "We're willing to accept losses if we can be confident in their ability to grow."

PayPal's success has grown out of a number of misfires. The technology was originally developed by a Silicon Valley startup called Confinity Inc., backed by

year-old CEO, Peter Thiel, and much of its management team—which averages 32 years of age—are from Confinity.

While the revamped PayPal is generating interest from some investors, it may not get a valuation that it likes. The company raised \$90 million in its last round of private funding in March, valuing the whole company at \$700 million, according to analysts. But PayPal's quest to hit that mark in an IPO appears to be a stretch. PayPal's publicly traded rivals, including CheckFree Corp., trade at about 2.5 times

PayPal's IPO Will Be A Tough Sell

On Sept. 28, the company that handles Internet payments for auctioneer eBay and others filed for an initial public offering, but it faces high hurdles:

DISMAL MARKET FOR IPOs

September was the first month since 1975 when not one company went public. Worse, only one Internet business has had an IPO this year, compared with 129 in 2000.

SCARY NUMBERS

Investors may cringe at PayPal's red ink, which totaled \$56.9 million in the first six months of this year on sales of \$34.2 million.

NO GRAYBEARDS

There aren't many seasoned executives at PayPal to assuage investor worries about experience. Its top 11 execs average 32 years of age, including a 33-year-old CEO.



BY ROBERT D. HOF

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Tech's Reliability Gap

Scattering employees may keep them safe, but networks aren't up to the task

It sounded like a reasonable response to the devastating attacks of September 11. Companies talked of reducing air travel, increasing their use of technologies such as videoconferencing and collaboration software, and further decentralizing operations through networks such as the Internet. In all of these measures, there's an assumption that technology is the key to making businesses not only safer but more stable and resilient.

Boy, I'm not so sure. When is the last time you said, "Wow, I just can't believe how dependable my personal computer is!"?

There's no doubt that computers, software, global networks, and the like have made us more efficient as corporations and as individuals. Tom DeMarco, a fellow with tech consultant Cutter Consortium's Business Technology Council, notes that some security measures, such as dispersing people and computers and using networks to connect them, have made us even more dependent on information systems. But all too many of these technologies are not only wide open to attack by hackers and fanatics, they're also absurdly unstable and unreliable. Relying on them still more, without making huge improvements in how they're designed and used, seems certain to compound the disruptions we've already seen.

The root problem is the very nature of technology development, notes Richard D. Pethia, director of the Computer Emergency Response Team Centers at Carnegie Mellon University's Software Engineering Institute. "Technology evolves so rapidly that vendors concentrate on time to market, placing a low priority on the security of their products," he said in recent testimony before a House subcommittee.

Even more worrisome is the low priority placed on basic reliability. One of the biggest challenges to distributed corporate operations may be bad software. According to information technology consultant Standish Group International Inc., bad software last year cost about \$175 billion worldwide in lost business due to downtime, more than double the amount two years ago. It makes you wonder if companies are ready to push more people into remote offices or even home to telecommute, where

technical support is shaky or nil. I can't tell you how many times my PC has inexplicably crashed, requiring on at least two occasions that it be sent to techies across the country to fix.

To the Internet's credit, key services such as e-mail and instant messaging held up amazingly well in the hours after the terrorist attacks. But the very strengths of the Internet may well increase the likelihood of widespread disruptions in the future. The nearly unstoppable global connections it forges among some 110 million computers online make it far easier to spread viruses and software bugs from a few computers to millions in an instant. Private networks may be better equipped to limit the impact of attacks and glitches. But even there, remote and small-office setups often use PC technologies that are more susceptible to viruses and just plain-old breakdowns.

This shaky situation suddenly makes cyber-attacks much less far-fetched than they once seemed. Viruses set loose by bored teenagers continue to bring corporations to their knees. It's not hard to imagine the havoc that a dedicated group of fanatics could unleash on the systems that we intend to depend on more than ever. Moreover, says Standish Group Chairman Jim Johnson, disaster recovery plans at all but two of 56 companies he surveyed recently are out of date, typically allowing them to return only 10% of their critical software applications to operation quickly. Says Johnson: "Disaster recovery is a disaster."

Most of these problems require big changes not only in technology, but in our thinking. Companies must make technology reliability a top priority and demand the same of their suppliers. Let's not fool ourselves: None of this can be fixed overnight. But I can't think of a better time to start. •



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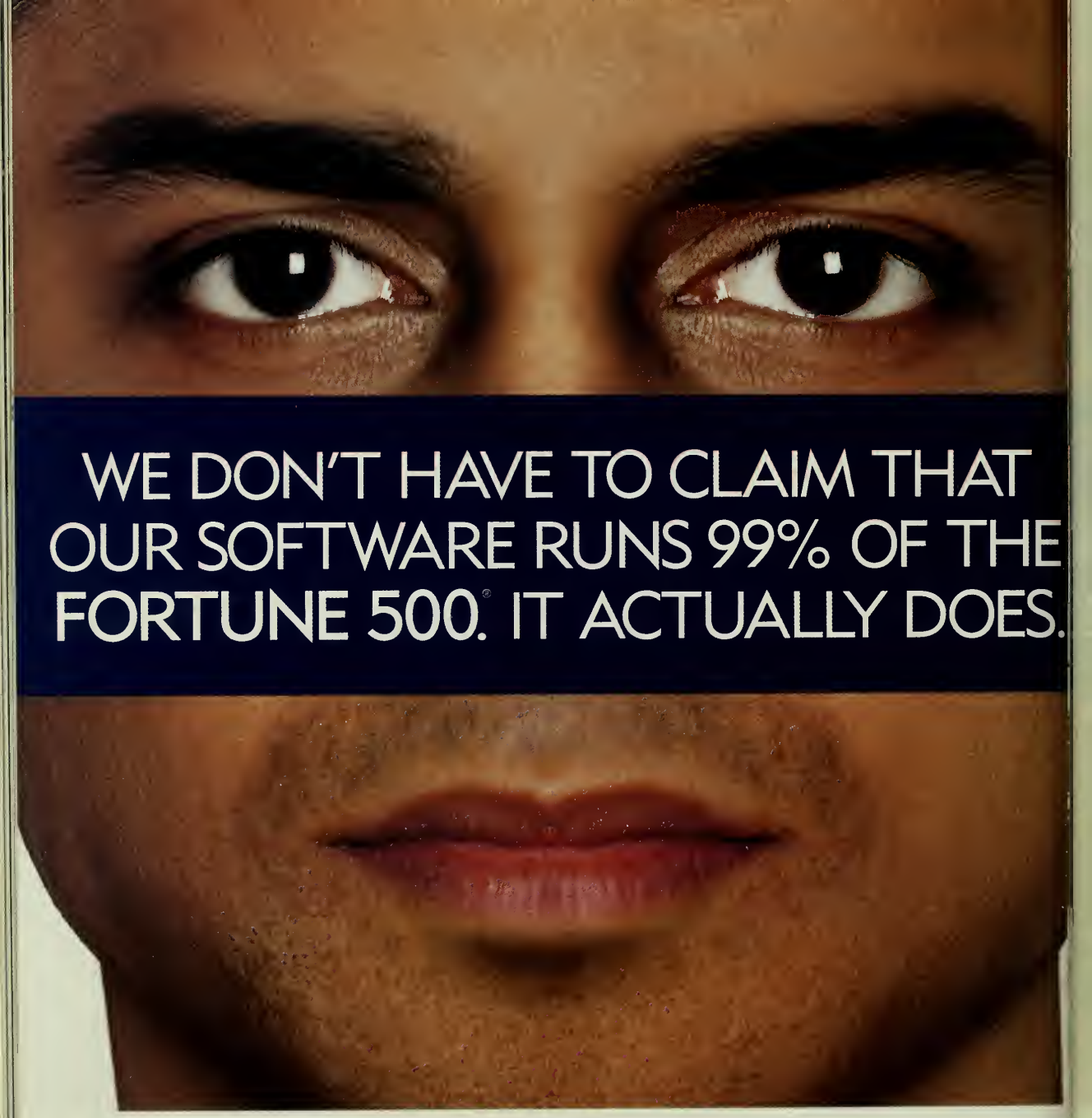
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